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The Economic and Fiscal Update

December 6, 1995

Canada

The Economic and Fiscal Update

December 6, 1995

Department of Finance Canada
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1

Introduction and Overview

Agenda: Jobs and Growth

This document is designed to facilitate the dialogue among Canadians on how best to continue the process of restoring the federal government's finances. It provides an update on the economic and fiscal situation and sets out the deficit target for 1997-98. It also explains the key linkages between the fiscal strategy and the government's top priority: ensuring that job creation and economic growth continue.

Economic growth resumed in the third quarter of 1995, after a pause in the first half of the year. This growth was led by strong export demand. While overall employment growth has been slow and volatile, 173,000 new jobs have been created in the private sector in the past 12 months.

To support its jobs and growth objectives, the Government will continue to pursue the strategy outlined in *A New Framework for Economic Policy* (October 1994).

As the "Framework" made clear, resolving Canada's debt and deficit problems is an integral part of the government's jobs and growth strategy. The creation of jobs and growth is hindered by the high real interest rates and economic uncertainty that accompany high levels of debt in relation to the size of the economy – the debt-to-GDP ratio. Indeed, the benefits that Canada has reaped from creating and maintaining a low inflation environment have been offset by the effects of the high debt-to-GDP ratio.

Efforts to sustain job creation and improve the standard of living, therefore, will be hamstrung until this issue has been brought under control.

Implementing the Fiscal Agenda

With its first budget, the government began the process of restoring Canada's finances and restoring credibility to the government's fiscal policy after years of missed deficit targets. By setting credible two-year rolling deficit targets, by using prudent economic assumptions for fiscal planning purposes, and by establishing Contingency Reserves to handle the impact of unforeseen economic developments on the achievement of the deficit targets, credibility is being restored to the nation's finances. The 1994 and 1995 budgets secured savings to begin turning around the deterioration in Canada's fiscal position. These budgets announced a series of policy reviews – most notably the comprehensive Program Review – charged with ensuring that federal programs were effective, cost-efficient and appropriate to the federal role in the Canadian federation.

1995 budget introduced major reform of government operations ...

The 1995 budget followed through on major government reform, based on the fiscal context set in the 1994 budget, and the policy themes elaborated in the "Framework" and its companion documents.[1] The budget set out the strategy for securing the government's interim deficit target of 3 per cent of GDP by 1996-97. It put in place $29 billion in cumulative fiscal actions over three years with expenditure reductions exceeding tax revenue increases by a ratio of seven to one.

... notably through Program Review ...

The expenditure reductions were based largely on the fundamental reform of government programs undertaken in Program Review. The Review directed government resources to the highest priorities, allowing for significant fiscal savings. As a result, the government took steps to get out of a

[1] These companion documents were: *Improving Social Security in Canada*, *Creating a Healthy Fiscal Climate*, and *Building a More Innovative Economy*.

number of areas where the private sector could deliver services more effectively and efficiently – notably transportation – and where government involvement has been found to have perverse effects – principally in subsidizing business. As the Organization for Economic Cooperation and Development (OECD) concluded:

> "Subsidies tend to operate in exactly the opposite way from what is needed: they slow rather than stimulate adjustment; they discourage rather than encourage innovation; and they tend to become permanent."

The 1995 budget also introduced reforms to the federal-provincial transfer system. It introduced the Canada Health and Social Transfer (CHST), which replaced transfers to provinces under the Canada Assistance Plan (CAP) and Established Programs Financing (EPF). The CHST provides the provinces more flexibility in allocating these transfers to areas of highest priority in their particular jurisdictions, while protecting medicare and residency requirements.

The budget also reduced tax preferences and increased the fairness of the tax system, while ensuring that taxes already owed are collected. Personal income tax rates were not raised in either the 1994 or 1995 budgets.

... which will ensure that the 1995-96 and 1996-97 fiscal targets are met

As a result of the actions in the last two budgets, real progress is being made in restoring Canada's fiscal health. The 1994-95 deficit target of $39.7 billion set out in the February 1994 budget was more than met. The deficit for 1994-95 was $37.5 billion, $2.2 billion below the February 1994 budget target. And despite an unexpected slowing in economic growth this year, the deficit targets for 1995-96 and 1996-97 will be met. The actions contained in the 1994 and 1995 budgets will reduce the deficit in relation to the size of the economy by 1996-97 to its lowest level in over 20 years.

Table 1.1
Federal deficit

	Actual		Forecast	
	1993-94	1994-95	1995-96	1996-97
$ billions	42.0	37.5	32.7	24.3
Per cent of GDP	5.9	5.0	4.2	3.0

The expenditure reductions on which the 1994 and 1995 budgets were based were structural in nature. Savings contained in the 1995 budget mature, for the most part, in 1997-98 and continue thereafter. Thus, decisions already made in the 1994 and 1995 budgets, as well as the recently announced unemployment insurance reform, will ensure that program spending – and the deficit – will continue to decline in 1997-98.

Ensuring Continued Progress

Previous governments set long-term deficit targets that were never realized. This government's approach to budgeting is to set credible two-year rolling deficit targets. By setting two-year deficit targets, discipline is maintained to ensure that the targets are met. The government is held accountable on an ongoing basis.

The government is proposing to set the 1997-98 deficit target at two per cent of GDP, or about $17 billion. This target will result in a permanent reduction in the debt-to-GDP ratio – the first time Canada's debt-to-GDP ratio has been on a sustained downward track since 1974-75. It is another important step toward the ultimate goal of a balanced budget.

Outline of the Paper

The remainder of this paper is organized as follows:

- **The Economic Assumptions** presented in the 1995 budget is updated in Chapter 2.

- **The Fiscal Implications of the Economic Assumptions** are discussed in Chapter 3

- **Creating a Healthy Monetary and Fiscal Climate** and in particular, why Canada's debt burden needs to be reduced, is discussed in Chapter 4.

- **Meeting the Challenge** posed by the large federal debt-to-GDP ratio and the changes in the economic environment since the 1995 budget is discussed in Chapter 5.

- **Conclusions and Main Issues** are presented in Chapter 6, including a number of specific questions on which the Finance Committee will be asked to provide advice.

As in last year's *Economic and Fiscal Update*, detailed descriptions of government spending and revenues are provided in the Annexes.

2

Economic Assumptions

Introduction – The Need for Prudence

This chapter begins with a review of recent economic developments and then presents private sector views on the prospects for 1996. Continuing with the approach used since the 1994 budget, a prudent alternative for fiscal planning is also presented. This prudent alternative was developed following the recommendation of the House of Commons Standing Committee on Finance that the fiscal forecast be based on interest rates above the average of private-sector forecasts, with consequential impacts on nominal GDP.

The use of prudent assumptions does not mean, however, that the government takes a gloomy view of Canada's economic prospects. Fiscal consolidation, structural reforms and a commitment to low inflation will lead to a strong economy. But the government's fiscal plan must allow for the possibility that the economic situation will be less favourable to fiscal consolidation than assumed, because of the high cost of failing to achieve deficit-reduction targets. Indeed, the use of prudent economic assumptions, backed by visible progress in reaching announced targets, offers the best hope of bringing forward the benefits of fiscal consolidation in the form of lower interest rates and hence better economic performance.

Recent Economic Developments

Growth paused in the first half of 1995

After growing strongly throughout 1994, the Canadian economy suffered a sharp decline in demand in the first half of this year. While some weakness was expected in the budget outlook for 1995, it came much sooner and was more pronounced than expected. Real GDP rose 1.4 per cent in the first quarter and then shrank 0.6 per cent in the second (annual rates).[1] The weakness would have been even more pronounced had there not been a large inventory accumulation in both quarters.

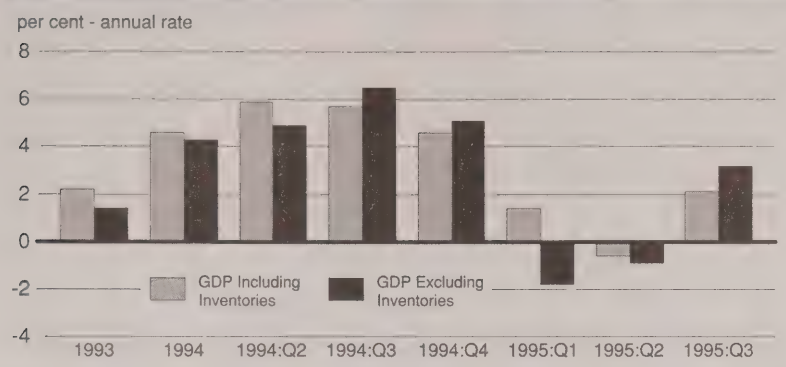
Both exports and domestic demand weakened dramatically. The weakness in exports followed growth of over 6 per cent in the second half of 1994. U.S. demand for Canada's exports fell sharply as U.S. industrial production trended down from January to June. Moreover, two key determinants of Canada's exports, U.S. motor vehicle sales and housing starts, fell 12 and 16 per cent respectively in the first half of the year.

Domestic demand also weakened in the face of rising interest rates, flagging consumer confidence and stagnant labour markets. Short-term interest rates rose more than 200 basis points from mid-1994 to early 1995, reflecting rising U.S. interest rates and heightened concerns about public sector debt. Further, the Conference Board's index of consumer confidence fell 12 per cent in the first half of the year. Finally, total employment was virtually stagnant through July after rising approximately 400,000 in the 12 months ending November 1994. As a result, consumer spending on goods and services stalled in the first half of the year and housing starts weakened substantially, falling to a 13-year low in July.

The weakness in overall employment, however, masked continued strong growth in the private sector offset by declining public sector employment. From November 1994 to July 1995, public sector employment fell 210,000 while private sector employment rose a healthy 206,000.

[1] Growth rates in this chapter are period-to-period changes calculated using seasonally adjusted data. The growth rates are not annualized unless explicitly noted.

Chart 2.1 Growth in GDP including and excluding inventory investment

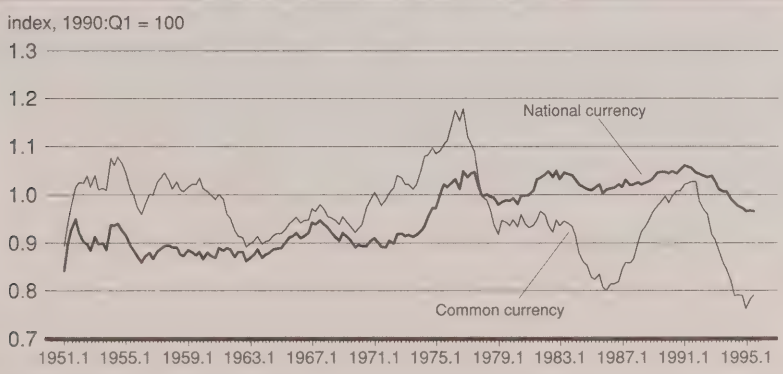


Inflation remains low

The 12-month rate of CPI inflation peaked at 2.9 per cent in May. The increase was largely due to temporary factors such as the pass through of the past depreciation of the dollar, rising indirect taxes, and increases in energy prices. The CPI was virtually unchanged from May to October, pushing the 12-month rate down to 2.4 per cent.

Inflation should ease further in the coming months given the amount of spare capacity in the economy, the virtual absence of domestic cost pressures and a relatively stable exchange rate. Wage settlements have averaged just under 1 per cent so far this year. Although the temporary weakness in output caused productivity to slip in the first half of the year, Canada's unit

Chart 2.2 Total economy relative unit labour costs (Canada relative to the United States)



labour cost performance over the past three years remains quite remarkable. While U.S. costs rose through this period, Canada's unit labour costs *fell* from the beginning of 1993 to the fall of 1994. An exchange rate depreciation pulled Canada's costs down much more sharply on a common currency basis and Canada's cost position relative to the U.S. remains at the lowest level in the 45 years the data are available.

Recent indicators are more promising

After plummeting from January to July, real merchandise exports surged almost 9 per cent in August and remained at this high level in September. This extraordinary performance caused the current account deficit to fall to $13.6 billion, equivalent to 1.7 per cent of GDP. This is down from 2.5 per cent of GDP in the first half of 1995 and is the lowest level since the second quarter of 1985. The prospects for continued export growth are good as U.S. economic activity has picked up after its own pause in the first half of the year.

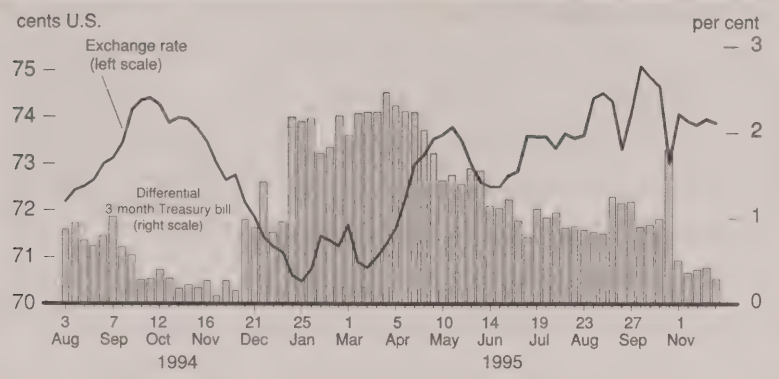
On the domestic side, household spending in the third quarter showed signs of recovering from its first-half slump as real consumer spending rose at an annual rate of 2.5 per cent, largely on the strength of car sales, and house resales picked up. The strength in consumption was not sufficient to offset weakness elsewhere and final domestic demand edged down in the third quarter. Nevertheless, real output rose 2.1 per cent (annual rate) in the quarter, faster than expected by most analysts.

While some weakness is evident in the most recent data, particularly employment in November, this is due in part to the financial market volatility and general uncertainty caused by the referendum.

Financial market sentiment has improved substantially

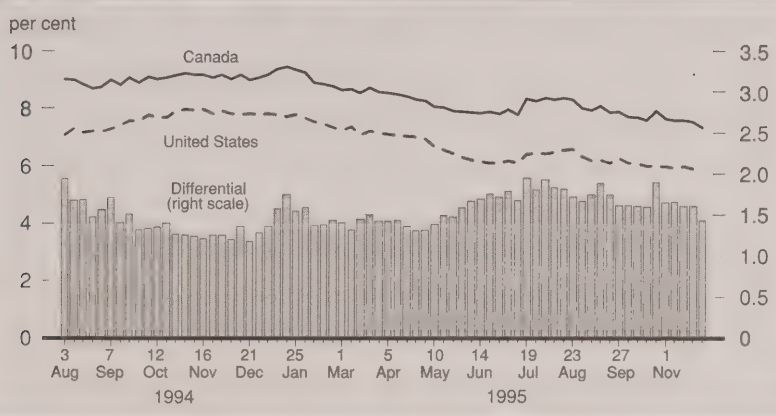
Financial market concerns reached a recent peak early in 1995 when the exchange rate fell to a nine-year low and Canada-U.S. short-term interest rate differentials rose above 200 basis points. Sentiment improved substantially over the spring and summer, due in part to the favourable reception given to the federal budget and the budgets of many provincial governments as well. Financial market concerns resurfaced in the late stages of the referendum campaign, causing a short-lived spike in interest rates and temporary weakness in the dollar.

Chart 2.3 Canada-U.S. exchange rate and the short-term interest rate spread



Since early 1995, the dollar has trended up and interest rates have fallen about 250 basis points. The short-term differential with the U.S. has fallen to under 50 basis points. Interest rate differentials on 10-year government bonds have also declined substantially since the referendum but remain high, suggesting ongoing concerns about public sector deficits and political uncertainty.

Chart 2.4 10-year bond rate



The External Economic Environment

Major overseas economies

Overseas growth performance has been markedly less favourable thus far in 1995 than expected at the time of the February budget. The rise in the value of their currencies against the U.S. dollar earlier this year hurt the export performances of Japan and Germany. At the same time, Japan continues to suffer from financial sector instability.

Japan is now expected to see its fourth consecutive year of almost no growth. The Japanese economy is expected to pick up gradually through 1996 but growth will remain below potential. Growth in the major European countries should be at, or perhaps slightly below, potential rates both this year and next.

All of the major overseas economies have spare capacity at present and this is expected to persist in 1996. This implies that inflation in most of the major overseas economies should remain around current low rates or even ease somewhat.

The United States

The U.S. economy looks well-placed to experience a soft landing rather than the more usual boom and bust expected at the time of the 1995 budget. Demand growth slowed in the first half of 1995 due to policy-induced rises in interest rates last year and weakness in foreign markets. This caused excessive inventories to accumulate and production to slow. Real growth fell from 5.1 per cent in the fourth quarter of last year to 1.3 per cent (annual rate) in the second quarter of this year. Employment growth slowed from 3.0 per cent to 1.0 per cent (annual rate) over the same period.

The slowing, however, served to ease capacity pressures and keep inflation pressures relatively low. As a result, CPI inflation excluding food and energy has stabilised at about 3 per cent.

Growth rebounded to an annual rate of 4.2 per cent in the third quarter, but this reflected a number of special factors that are not likely to recur in the fourth. These special factors included a jump in government spending and a surge in motor vehicle sales in August in response to end-of-model-year rebates and incentives. As a result, most private sector forecasters expect growth to slow to about the economy's potential growth rate (approximately 2½ per cent) in the fourth quarter. Growth is then expected to remain near potential through next year.

Table 2.1
Economic assumptions for the United States – Private sector average

	Actual	Forecast	
	1994	1995	1996
Real GDP growth	4.1	3.2	2.6
CPI inflation rate	2.6	2.9	2.9
Unemployment rate (%)	6.1	5.6	5.7
90-day Treasury bill[1] (%)	4.4	5.7	5.5
10-year government bond rate[2] (%)	7.1	6.6	6.2

Source: Blue Chip Economic Indicators, November 10, 1995. This is a survey of 50 U.S. private sector forecasters.

[1] True yield, adjusted from discount basis by the Department of Finance.

[2] Based upon Blue Chip Consensus for the corporate AAA rate.

The stable inflation outlook allows short-term interest rates to remain near their end-November level of 5.5 per cent. The 10-year bond yield, however, moves up slightly through next year from just under 6.0 per cent. In the budget, short and long-term interest rates were assumed to peak well above these levels, at 7½ and 8¼ per cent respectively.

The Economic Assumptions for Canada

Private sector views

Private sector views on the economic outlook for Canada are summarised in Table 2.2. Although some of these forecasts were prepared quite recently, the majority were prepared from mid-September to mid-October. They are consistent with the views of the 10 private sector economists that appeared before the House of Commons Finance Committee on November 9. The forecasts do not, however, reflect the most recent data, particularly the national income and expenditure accounts for the third quarter, and the labour market data for October and November. On balance, these data suggest that real growth in 1995 is likely to be closer to 2½ per cent than the 2.2 per cent reported in the survey.

Private sector forecasters generally expect economic performance to improve in 1996 due to a favourable external environment and interest rates that are lower than in 1995 As a result, both exports and domestic demand are expected to make solid contributions to growth. Since most forecasts

were prepared with the expectation of a solid "no" vote in the referendum, the survey does not take account of the potentially damaging effect of heightened political uncertainty on confidence and growth.

Private sector forecasters expect short-term interest rates to average 6.3 per cent in 1996 while the interest rate on 10-year government bonds is expected to average 7.8 per cent. These are somewhat lower than on average in 1995, but they are about 50 basis points above end-November levels. Economic fundamentals and a sound policy framework suggest the current low interest rates are likely to be sustained in the near term and that further progress could be made in 1996:

- credible progress is being made by all levels of government in reducing budget deficits;
- the government and the Bank of Canada are committed to keeping inflation low, reinforcing Canada's excellent competitive position.

Table 2.2
Economic assumptions for fiscal planning[1]

	1995	1996
Real GDP growth (%)		
Private sector average	2.2	2.4
Prudent alternative	2.2	2.3
Nominal GDP growth (%)		
Private sector average	4.0	4.3
Prudent alternative	4.0	4.1
Nominal GDP ($ billions)		
Private sector average	780	814
Prudent alternative	780	812
CPI inflation		
Private sector average	2.3	2.2
Prudent alternative	2.3	2.2
91-day Treasury bill (%)		
Private sector average	6.9	6.3
Prudent alternative	6.9	6.8
10-year benchmark government bond rate (%)		
Private sector average	8.0	7.8
Prudent alternative	8.0	8.3

[1] The private sector average is based on 19 respondents for 1995 and 1996.

On the other hand, a loss of confidence in financial markets – perhaps due to increased political uncertainty – could put substantial upward pressure on interest rates.

Private sector analysts expect real growth will average 2.4 per cent in 1996, up slightly from this year. Growth from the end of this year to the end of 1996 is, however, expected to be substantially stronger at almost 3½ per cent. Employment is forecast to rise 1.4 per cent in 1996. This is not, however, sufficient to reduce the unemployment rate substantially from its level in November.

CPI inflation is expected to average about 2¼ per cent in 1996, virtually unchanged from 1995. Economy-wide inflation will be somewhat lower, but again little changed from this year.

A prudent alternative for fiscal planning

This government has adopted the approach of using economic assumptions that are prudent in the sense that they skew the risks in favour of reducing the deficit more than assumed. This does not mean that the government takes a pessimistic view of Canada's economic prospects. Economic performance is more likely than not to be better than set out in the planning assumptions *as the government makes credible progress meeting its fiscal targets*. If the targets are not met, economic performance is likely to be worse due to higher interest rates and lower confidence. It is important to stress that if the economy does perform better than assumed, the government will use the fiscal gain to achieve its long-run deficit target faster, which will reinforce the good economic performance.

In its report last fall, the House of Commons Finance Committee stressed that the large stock of outstanding debt made the interest rate planning assumptions crucial because of the extreme vulnerability of the deficit to interest rate swings. As a result, the Committee recommended that the economic assumptions for fiscal planning be based on interest rates that are 50 to 100 basis points higher than the private sector average. Given the substantial improvement in financial market sentiment since the private sector forecasts were prepared, it is appropriate to apply a 50 basis point prudence factor to the private sector average. This lowers nominal GDP growth about 0.2 percentage point in 1996, and reduces the level of nominal GDP by $2 billion. This impact on nominal GDP has been split evenly between real income and inflation.

The fiscal implications of using the prudent planning scenario are explored in the next chapter. The appropriate degree of prudence will, of course, be re-examined during the pre-budget consultations and revised if necessary for the budget.

Comparison with the budget economic assumptions

The outlook for real growth in 1995 has been reduced sharply since the budget, from 3.8 to 2.2 per cent. Although growth is assumed to pick up in 1996, the level of real GDP in the prudent alternative remains below the budget assumption. In contrast, the outlook for inflation has edged up since the budget. Overall, the 1996 level of nominal GDP, which is a reasonable proxy for the tax base, is about $9 billion lower in the prudent planning scenario than was assumed in the budget.

Interest rates in 1995 have come in much lower than expected in the budget, offsetting completely the impact of slower growth on the fiscal deficit. Interest rates in 1996 are now assumed to be 70 basis points lower than in the budget.

Table 2.3
Updated prudent economic assumptions for Canada

	Actual	Forecast	
	1994	1995	1996
Real output growth (%)			
Budget 1995	4.3	3.8	2.5
Fall update	4.6	2.2	2.3
GDP deflator increase (%)			
Budget 1995	0.6	1.6	1.8
Fall update	0.6	1.9	1.9
Nominal GDP growth (%)			
Budget 1995	4.9	5.5	4.3
Fall update	5.2	4.0	4.1
Nominal GDP ($ billions)			
Budget 1995	746	787	821
Fall update	750	780	812
91-day Treasury bill rate (%)			
Budget 1995	5.5	8.5	7.5
Fall update	5.5	6.9	6.8
10-year government bond rate (%)			
Budget 1995	8.4	9.7	9.0
Fall update	8.4	8.0	8.3

3

The Fiscal Implications of the Economic Assumptions

Final Deficit Outcome for 1994-95

The government's *Annual Financial Report*, released November 1, 1995, reported that the 1994-95 deficit was $37.5 billion, $2.2 billion below the target of $39.7 billion set out in the 1994 budget and $4.5 billion below the 1993-94 deficit outcome of $42.0 billion.

The deficit outcome for 1994-95 underscores the importance of basing the fiscal projections on prudent economic assumptions. Economic conditions changed significantly during the course of 1994 from what was expected at the time of the February 1994 budget. Economic growth turned out to be more robust than forecast, but interest rates were substantially higher. However, because the deficit forecast for 1994-95 was based on prudent economic assumptions, the net effect was that most ($2.2 billion) of the $2.4 billion Contingency Reserve established in the 1994 budget was not needed.

Fiscal Implications of Economic Assumptions

The key factor affecting the fiscal update is the changed economic outlook, as described in Chapter 2. That chapter provided an update of economic developments for 1995 and 1996 from those presented in the February 1995 budget. It also provided a prudent economic scenario for fiscal planning purposes for 1995-96 and 1996-97.

1995-96

The deficit target for 1995-96, as first put out in the February 1994 budget and restated in the February 1995 budget, is $32.7 billion.

As explained in Chapter 2, economic growth in 1995 will be substantially less than expected at the time of the February 1995 budget. Thus, tax revenue will be lower than had been expected. However, interest rates have also been much lower during 1995 than expected in the 1995 budget, thereby resulting in lower-than-expected public debt charges.

On balance, the impacts of lower growth and lower interest rates on the deficit are expected to be offsetting. This is supported by the financial results for the first six months of 1995-96. The deficit over the April to September 1995 period was $1.3 billion below the deficit for the same period last year. This improvement, coupled with the inclusion of a number of one-time restructuring costs in the 1994-95 deficit outcome, clearly indicates that the 1995-96 deficit target of $32.7 billion will be met.

Table 3.1
Changes to the 1995 budget deficit track

	1995-96	1996-97
	(billions of dollars)	
February 1995 budget deficit track	32.7	24.3
Changes:		
Revenues		
Personal income tax	0.5	1.0
Corporate income tax	1.2	0.6
Other	0.3	-0.3
Total revenue changes	2.0	1.3
Program spending		
U.I. benefits	-0.7	0.4
CHST	0.3	0.1
Other spending	0.1	0.2
Total program spending	-0.3	0.7
Public debt charges	-1.7	-1.5
Net impact of changes	0.0	0.5
Contingency Reserve	0.0	-0.5
Total changes	0.0	0.0
Revised deficit with unchanged policy	32.7	24.3

Note: Negative sign indicates a reduction in the deficit.
Positive sign means an increase in the deficit.

1996-97

The deficit target for 1996-97 of $24.3 billion, or 3 per cent of GDP, also remains on track, despite the changes in the economic planning assumptions since the February 1995 budget. Using the prudent economic planning assumptions, both the level of nominal income and interest rates are expected to be lower than forecast at the time of the February 1995 budget.

Budgetary revenues, especially personal and corporate income taxes, are now expected to be $1.3 billion lower than forecast in the 1995 budget. The Minister of Human Resources Development recently proposed major reforms to the unemployment insurance program, including changes to the earnings base used to calculate premium contributions. The premium rate equivalent to generate the premium contributions assumed in the 1995 budget would need to be $2.93 per $100 of insurable earnings (employee rate). The rate for 1996 has, therefore, been set at $2.95 per $100 of insurable earnings. This compares to a rate of $3.00 per $100 of insurable earnings in 1995.

Program spending is expected to be somewhat higher than forecast in the 1995 budget. This reflects the impact of higher cash transfers under the Canada Health and Social Transfer, slightly higher unemployment insurance benefit payments, and some adjustments to other program spending. The fiscal impact of the proposed changes to unemployment insurance benefits was included in the 1995 budget projections for 1996-97. The proposed changes, therefore, secure these savings. As a result, the operating surplus is expected to be $2.0 billion lower than forecast in the 1995 Budget.

Largely offsetting this deterioration in the operating balance are lower public debt charges, as interest rates for 1996 are expected to be lower than assumed in the 1995 budget.

Included in the fiscal projections is a Contingency Reserve. This is included in the deficit projections primarily to cover risks arising from (i) unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and (ii) unpredictable events. The contingency reserve provides an extra measure of back-up against adverse errors in the economic forecast. The contingency reserve is not a source of funding for new policy initiatives.

The Contingency Reserve for the first full fiscal year of the upcoming budget planning cycle is set at $2.5 billion, as per current budget practice. Future years' Contingency Reserves are set a $3.0 billion per year. In the 1995 budget, the Contingency Reserve for 1996-97 was $3.0 billion, as that was the second year of the planning horizon at that time. Lowering the Contingency Reserve for the first year of the budget planning cycle reflects the fact that the risks to the planning assumptions are lower than in succeeding fiscal years.

With the revisions outlined above, the deficit target of $24.3 billion for 1996-97 is met.

Financial requirements – a measure of net market borrowing – will decline sharply, from $24.9 billion in 1995-96 to $13.7 billion in 1996-97. This represents 1.7 per cent of GDP, the lowest requirement, relative to the size of the economy since 1974-75.

Table 3.2
Summary statement of transactions: status quo fiscal extension

	1994-95	1995-96	1996-97
	(billions of dollars)		
Budgetary revenues	123.3	131.2	136.1
Program spending	118.7	113.7	108.6
Operating balance	4.6	17.6	27.4
Public debt charges	42.0	47.8	49.2
Contingency Reserve	0.0	2.5	2.5
Deficit	-37.5	-32.7	-24.3
Non-budgetary transactions	11.6	7.8	10.6
Financial requirements	-25.8	-24.9	-13.7
Net public debt	545.7	578.4	602.6
GDP (calendar year)	750	780	812
Per cent of GDP			
Revenues	16.4	16.8	16.8
Program spending	15.8	14.6	13.4
Deficit	-5.0	-4.2	-3.0
Financial requirements	-3.4	-3.2	-1.7
Net public debt	72.8	74.2	74.2

Financial requirements form the basis for the amount of Borrowing Authority requested from Parliament for a fiscal year. The Borrowing Authority that would be associated with financial requirements of $13.7 billion in 1996-97 would be $17.7 billion. This is down sharply from the Borrowing Authority of $28.9 billion for 1995-96 shown in the 1995 budget.

Financial requirements are also a more comparable measure of the government's fiscal position on an international basis, in particular with respect to the United States. On this basis, Canada's fiscal performance in 1996-97 will be significantly better than in the United States and will be projected to be the lowest among central governments of G-7 countries.

Fiscal Outlook: Sensitivity to Economic Assumptions

Estimates of the main fiscal aggregates are sensitive to changes in economic assumptions - particularly the level of nominal income and interest rates. The following sensitivity estimates are intended to capture the direct fiscal impacts of changes, one economic variable at a time. These are partial calculations. For example, in the nominal income sensitivity estimate, there is no feed-through of the change in nominal income to other variables, such as interest rates and unemployment.

Sensitivity to changes in nominal income

A 1-per-cent increase in the level of nominal income leads to higher tax bases and therefore higher revenues. Expenditures are lower, primarily due to lower interest costs since the stock of debt is smaller than it otherwise would be.

The deficit impact would depend on the source(s) of the increase in nominal income. The most favourable impact on the fiscal situation would occur if all of the increase in nominal income was due to an improvement in productivity. Inflation and interest rates would not rise and indeed could decline. Revenues would be higher and borrowing costs lower.

If, however, the improvement were solely due to inflation, then some of the positive impact on government revenues would be offset by higher spending on those programs that are indexed to inflation. In addition, higher nominal GDP, caused either by higher inflation or stronger demand in the economy, would likely raise interest rates, thereby increasing public debt charges.

Assuming the increase in nominal incomes comes solely from an increase in real output, the deficit would be lower by $1.3 billion in the first year and would be lower by $1.7 billion after four years, as savings from lower debt charges begin to accumulate.

Table 3.3
Fiscal sensitivity analysis: 1-per-cent increase in the level of nominal income

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue increases	1.2	1.3	1.4	1.6
Expenditure reductions	0.1	0.2	0.1	0.1
Deficit reduction	1.3	1.5	1.5	1.7

Sensitivity to changes in interest rates

In contrast to the uncertainties of the sensitivity of the deficit to changes in nominal GDP, the impact of interest rate changes on public debt charges can be calculated with considerable precision. A sustained 100 basis point decline in all interest rates causes the deficit to decline by $1.5 billion in the *first* year.[1] As longer-term debt matures and is refinanced at lower interest rates, the favourable impact on the deficit increases, such that by year four, the deficit is about $3.4 billion lower.

Table 3.4
Fiscal sensitivity analysis: 100-basis-point decline in all interest rates

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue decreases	0.3	0.3	0.4	0.4
Expenditure reductions	1.8	2.8	3.4	3.8
Deficit reduction	1.5	2.5	3.0	3.4

[1] This estimate is slightly lower than previous estimates as more of the debt is now being financed at longer maturities.

As the above clearly illustrates, an important consideration in managing the federal debt is the impact on debt charges of unexpected increases in interest rates. The potential for unexpected variations in debt charges, especially in the short run, can be modified by changing the structure of the outstanding debt. A larger proportion of fixed-rate debt reduces the sensitivity of debt charges to interest rates. Over the past year, the government has been moving to a higher portion of fixed-rate debt and has set out a target to increase its fixed-rate proportion from 55 per cent to 65 per cent by the end of 2004-05. For further details on the government's debt management strategy see *Debt Operations Report,* December 1995.

4

Creating a Healthy Monetary and Fiscal Climate

The government's strategy paper *A New Framework for Economic Policy*, released October 1994, set out the context and broad directions for the government's jobs and growth strategy. It argued the importance of creating a healthy monetary and fiscal climate, not just because it is fundamental to strong economic performance in its own right, but because it is also essential if the government is to have the public trust and the resources necessary to tackle its responsibilities in other areas.

This government remains committed to keeping inflation within a band of one to three per cent, which will contribute to a more stable and attractive business climate.

The government has also laid the groundwork for restoring fiscal health. The 1994 and 1995 budgets put in place reforms to achieve the interim deficit target of three per cent of GDP by 1996-97 – the lowest such ratio since 1974-75. Measures put in place in these budgets will ensure that the deficit continues to fall in relation to GDP in the future.

But the job of restoring health to Canada's public finances is not yet complete. This chapter will focus on the fiscal challenge posed by Canada's high debt-to-GDP ratio. This problem is not just a matter for businesses and financial markets. It affects all Canadians profoundly.

The Ongoing Challenge of Canada's High Debt-to-GDP Ratio

The government is focusing on the debt-to-GDP ratio because this is a measure of the country's ability to service the debt. GDP is an estimate of total income generated in the economy. It is akin to total income in a household. Just as a household with a larger income can support a larger mortgage, an economy with a larger GDP can support a larger public debt.

This government will reduce the debt-to-GDP ratio both by eliminating the source of that debt – ongoing deficits – and by increasing the growth potential of the economy. As the rest of this chapter explains, these two approaches are complementary. Lowering the deficit will soon put the debt-to-GDP ratio on a downward track. Lowering the deficit will also lower interest rates, which will bolster economic growth and, thus, further reduce both the deficit and the debt-to-GDP ratio. Structural changes to support and enhance economic efficiency will lead to more jobs and higher incomes. This, in turn, will result in higher revenues to the government and lower spending, thereby reducing the deficit further.

Achieving a significant reduction in the debt-to-GDP ratio involves difficult choices. Many of these choices were made in the 1994 and 1995 budgets, but more are still to come.

The urgency of reducing the debt-to-GDP ratio was clearly stated in the government's strategy paper *Jobs and Growth: A New Framework for Economic Policy:*

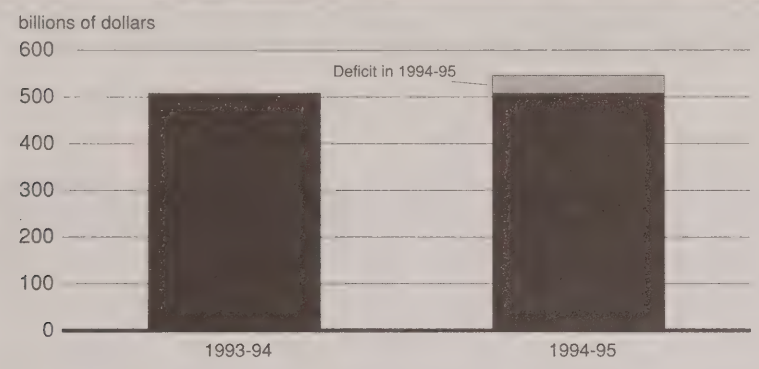
> "Increasing productivity and sustained job growth are the results of investment, of entrepreneurial vigor, and of consumer confidence. All are being undermined by a growing public debt that has led to higher taxes, higher real interest rates, and a diminished capacity of the Government of Canada to address the other vital issues of an economic strategy for the future."

The Auditor General has also drawn attention to the implication of the growing government debt-to-GDP ratio. In his 1995 report to the House of Commons *Deficits and Debt: Understanding the Choices,* the Auditor General writes:

> "Today when the debt-to-GDP ratio is four times higher than it was 20 years ago, the cost of stabilizing it is significantly higher, as is the cost of letting it continue to rise. In short, the choices available to us have become much more painful."

The federal debt-to-GDP ratio did not increase suddenly and its momentum will not be turned around quickly. The federal Government has been spending more than it collects in revenues *for 25 consecutive years.* In 1994-95, the government ran a deficit of $37.5 billion. As a result, the public debt increased by $37.5 billion that year (Chart 4.1). Persistent deficit financing has pushed the federal debt up from $20 billion in 1971 to over $545 billion as of March 31, 1995.

Chart 4.1 Net public debt



The debt has been increasing faster than the country's ability to pay for it. Chart 4.2 shows that since 1974-75, the stock of debt has grown faster than GDP. This is because deficits have ratcheted up in periods of economic weakness but failed to decline significantly in economic expansions. As a result, Chart 4.3 shows that the federal debt-to-GDP ratio has increased from 19 per cent in 1974-75 to 73 per cent in 1994-95.

Chart 4.2 Annual growth in federal debt and GDP

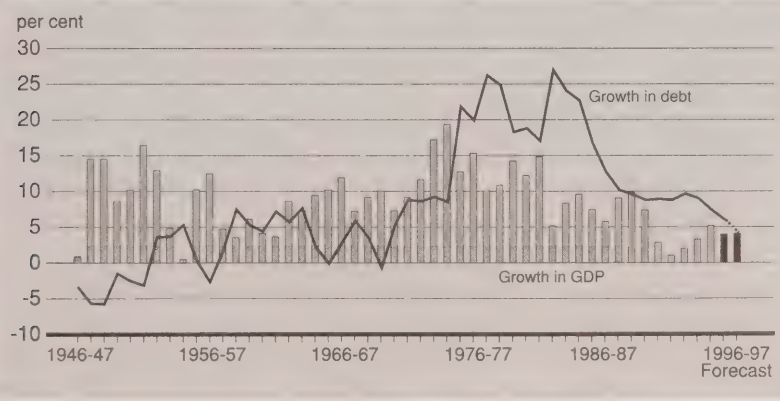
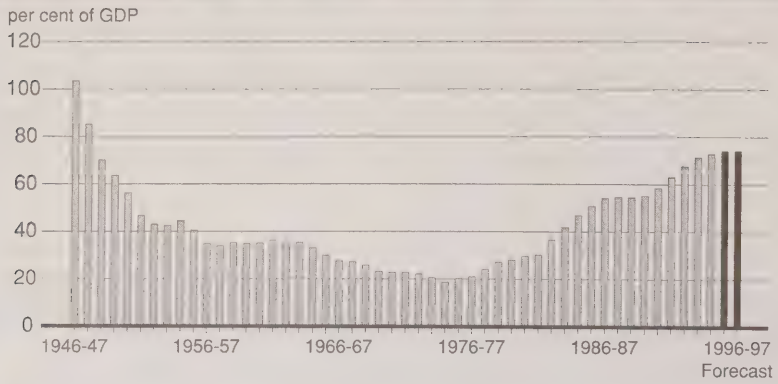


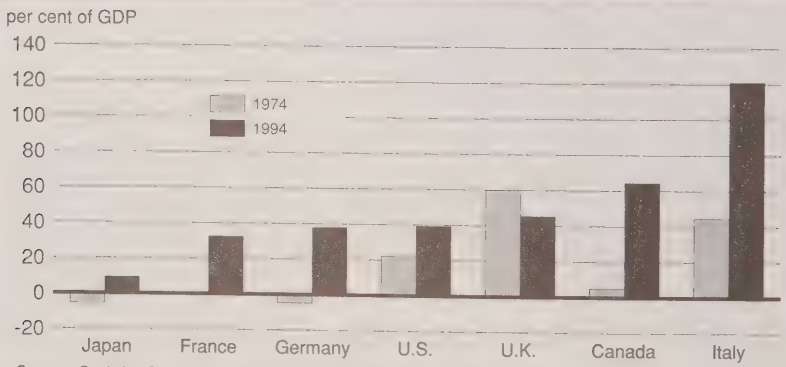
Chart 4.3 Federal government net debt (Public Accounts basis)



Other countries have also experienced increases in their debt-to-GDP ratios over this period. However, few have experienced as pronounced an increase as Canada. Chart 4.4 shows that in a little over twenty years, Canada has moved from having a relatively low debt-to-GDP ratio to having the second highest debt burden of the world's seven largest economies (G-7). (Debt-to-GDP ratios by country are reported on a National Accounts basis as only these data are consistent across countries. The debt-to-GDP ratio on a National Accounts basis is significantly smaller than on a Public Accounts basis.)

In addition, many countries with markedly lower debt-to-GDP ratios than Canada are now concerned that their own debt is excessive. France, Germany and the United Kingdom all have lower debt-to-GDP ratios than Canada, but have put in place reforms to lower their ratios even further.

Chart 4.4 Total governement net fiscal debt – G-7 countries
(National Accounts basis)



Source: Statistics Canada for Canada OECD estimates for other countries.

Germany is well on the way to meeting the Maastrich requirement of a deficit-to-GDP ratio of 3 per cent by 1997 and a gross general government debt-to-GDP ratio of below 60 per cent. France too is committed to meeting these objectives, while the United Kingdom is committed to eliminating its borrowing requirements by 1998-99.

The cost of servicing Canada's debt is crowding out all other spending. Roughly 30 per cent of total spending is now going to pay debt charges, with the remaining 70 per cent devoted to programs (Chart 4.5). This is in sharp contrast to the mid-1970s when only 10 percent of spending was on debt charges. By next year, public debt charges will equal all spending by federal departments other than transfers to persons and to other levels of government (Chart 4.6). The vicious circle of compound interest is crowding out programs that Canadians want and need.

Chart 4.5 Composition of total budgetary expenditures

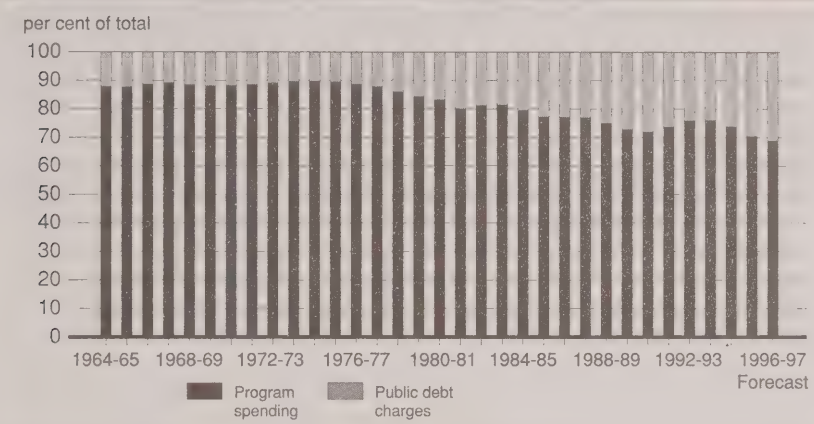
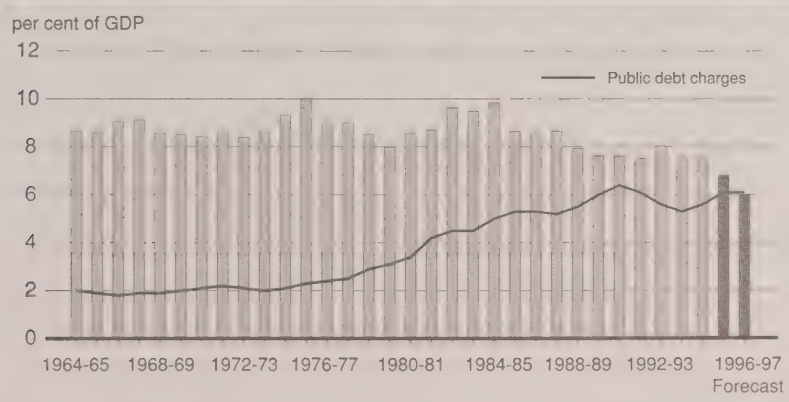
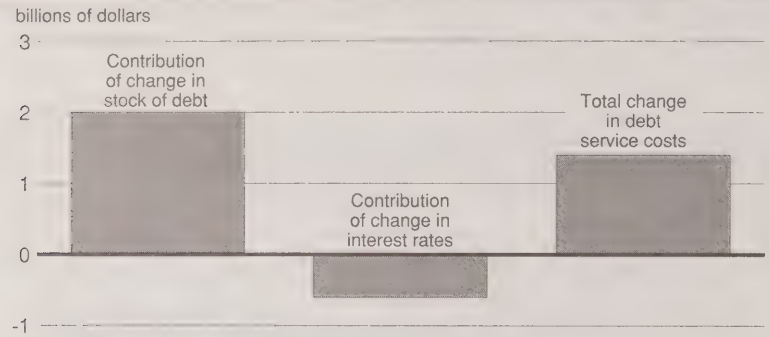


Chart 4.6 Total departmental spending



Debt servicing costs are largely increasing because of the rising stock of debt. Lower interest rates alone will not be sufficient to reduce the debt-to-GDP ratio. For example, by 1996-97 the effective interest rate on the debt is expected to decline, which will lower debt servicing costs in that year by $600 million. However, this decline will be offset by the effect of the deficit, which is expected to raise debt servicing costs by $2 billion. Thus, total debt servicing costs are expected to increase $1.4 billion in 1996-97.

Chart 4.7 Contribution to change in debt service costs 1996-97



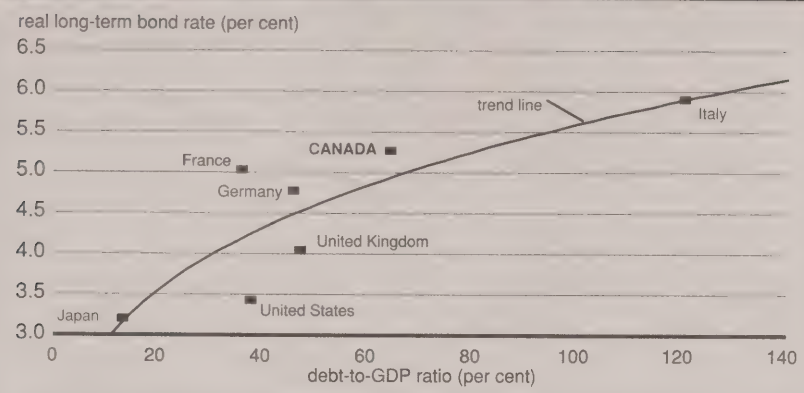
The Consequences of a High Debt-to-GDP Ratio

Canada's high debt-to-GDP ratio ultimately threatens to slow job creation and growth. In terms of its impact on the economy, the debt build-up represents one of the most significant – albeit dubious – developments of recent times, alongside the globalization phenomenon, the development of the information economy and the emergence of dynamic newly industrialized (and industrializing) countries. Unlike these positive developments that offer tremendous economic opportunities, the high debt-to-GDP ratio has brought with it a number of severe economic consequences which threaten the Canadian standard of living.

High interest rates

Canada's high debt-to-GDP ratio is keeping interest rates high. Interest rates rise and fall virtually every day, but comparing interest rates and government debt-to-GDP ratios across countries and provinces clearly suggests that debt and interest rates are linked.

Chart 4.8 Real interest rates and debt-to-GDP ratios in G-7 countries



Real interest rates calculated using interest rates on November 22, 1995 and the October 1995 year-over-year change in the CPI.

Debt/GDP ratios are for 1994.

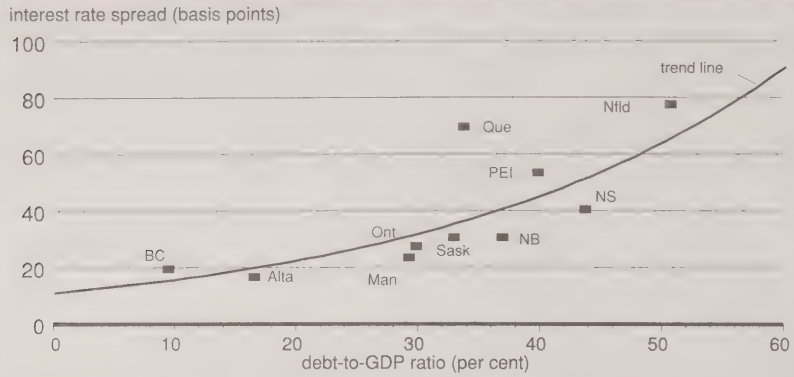
Canada and Italy have the highest debt-to-GDP ratios and the highest real rates of interest (adjusted for inflation) in the G-7 (Chart 4.8). Japan, on the other hand, has the lowest debt-to-GDP ratio and the lowest interest rate.

Of course, differences in interest rates across countries are not just determined by debt burdens. Other factors, such as the degree of political stability and average rates of taxation, also come into play. However, excessive debt is now clearly among the primary factors keeping interest rates high in Canada. Research by the Organization for Economic Co-operation and Development and the International Monetary Fund suggests that high government debt has offset much of the reduction in interest rates that should have resulted from Canada's excellent inflation performance.

The relationship between debt-to-GDP ratios and interest rates is even more apparent in the different rates of interest paid by provincial governments (Chart 4.9). The higher a province's debt-to-GDP ratio, the higher the interest rate demanded by financial markets. British Columbia and Alberta, which have relatively low debt-to-GDP ratios, pay the lowest interest rates. Newfoundland and Nova Scotia are among the most indebted provinces and also face the highest interest rates.

As the rate of interest paid by the federal government sets the standard for all other borrowers, the high federal debt-to-GDP ratio raises interest rates throughout the economy. These high interest rates are lowering consumer demand and making it more costly to invest and produce in Canada.

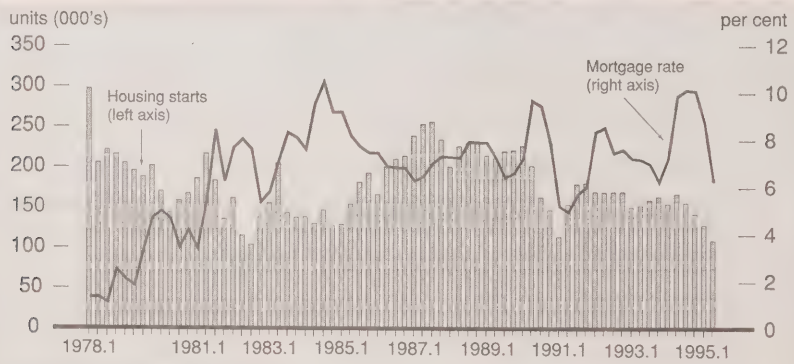
Chart 4.9 Debt-to-GDP ratios and interest rates by province



Interest rate spreads relative to 10-year Government of Canada bond rate as of Nov.'95.
Debt/GDP ratios are 1994-95 Department of Finance estimates.

Canadians have first-hand experience with the effects of high interest rates. For example, a 200 basis point increase in mortgage rates increases the cost of a $100,000 mortgage by $135 per month, or $1,624 per year. When mortgage rates rise, housing starts fall. A similar relationship holds for purchases of such items as automobiles, consumer appliances and furniture (Chart 4.10).

Chart 4.10 Real 5-year mortgage rate and housing starts



Housing starts are lagged two quarters.

Small and medium-sized businesses – a key engine of growth in the Canadian economy – are particularly affected by high interest rates because they have few alternative sources of financing. With a 200 basis point increase in interest rates, the cost of a $2,000,000 loan to a small business increases by $28,000 per year.

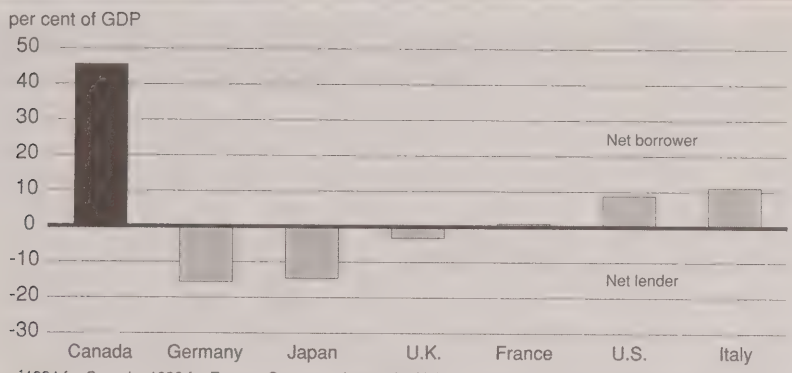
Indeed, the effects of high interest rates are felt throughout the economy. The Department of Finance estimates that a sustained 200 basis point

increase in interest rates lowers real GDP by 2¼ per cent and employment by 140,000 after four years. Estimates of the impact of interest rates by other organizations show similar results.

High foreign debt

Persistent government deficits also lower investment spending by soaking up money that could be used for productive investments. Many investments by Canadian firms now must be financed by borrowing from foreigners. As a result, Canada has the highest external debt-to-GDP ratio in the G-7 (Chart 4.11).'

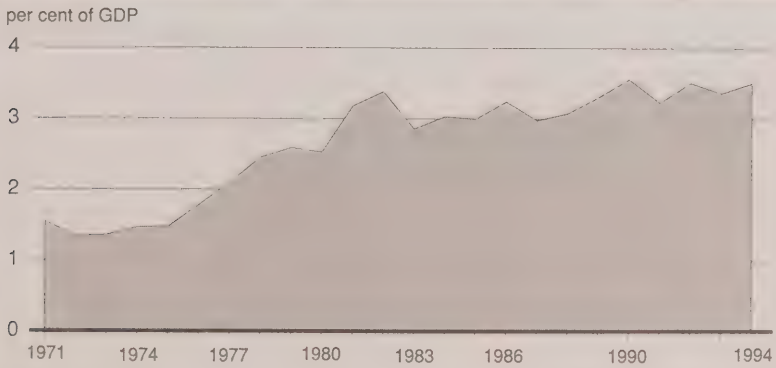
Chart 4.11 G-7 countries' net international investment position[1]



[1]1994 for Canada. 1993 for France, Germany, Japan, the United States and the United Kingdom. 1992 for Italy.

Accordingly, a rising share of income generated in Canada has been flowing abroad to pay for the debt (Chart 4.12). This represents a permanent deterioration in the country's potential standard of living. And it means that non-residents are indirectly exercising greater influence over economic decisions made in Canada.

Chart 4.12 Net investment income paid to non-residents

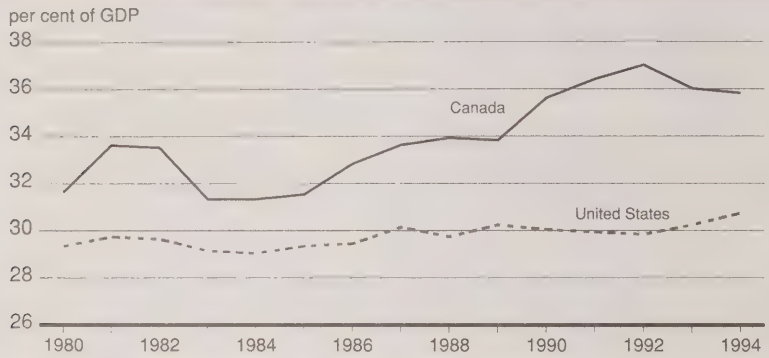


High taxes

Since the early-1980s the tax burden in Canada has increased significantly, and much more rapidly than that in the United States – our largest trading partner (Chart 4.13). Higher overall relative taxes in Canada have always reflected a higher level of public services, many of which have contributed to the fairness and quality of Canadian life. But over the last decade, as the cost of servicing the debt has risen, taxes were raised and program spending cut in order to service the rising debt.

These tax increases are detrimental to employment and output growth. The rising debt-to-GDP ratio also increases the risk of future tax increases, which further erodes Canada's attractiveness as an investment location.

Chart 4.13 Canada and U.S. – Total tax revenue



Source: OECD *Revenue Statistics of OECD Member Countries, 1968-1993.*

Deficit vulnerable to recessions and high interest rates

The high federal debt-to-GDP ratio has also left the fiscal situation extremely vulnerable to economic slowdowns and increases in interest rates. Although the low inflation that Canada now enjoys reduces the risk of "boom and bust" economic cycles, no economy is recession-proof. This is especially true of an open economy like Canada, which is directly affected by developments in the economies of its major trading partners.

In particular, one cannot rule out interest rate shocks in response to financial market pressures in the world's largest economies or trading blocs. The increase in U.S. rates in 1994, due to inflation fears, and the increases in rates in late 1994 and early 1995, due to the Mexican currency crisis, are two examples of how developments in other countries affect interest rates in Canada.

To miminize the short-term negative effects of interest rate increases on the deficit, the government has been lengthening the term structure of its debt. Yet a 100 basis point increase in interest rates still raises the deficit by $1.5 billion in the first year and by $3.4 billion after four years. This large impact would upset even the best-laid budget plans. A more complete discussion of fiscal sensitivities to changes in income growth and interest rates is provided in Chapter 3.

Just as importantly, high deficits and a high debt-to-GDP ratio have eroded much of the government's policy flexibility – including its ability to buffer the economy from the negative effects of recessions. In 1990-91 the rising debt-to-GDP ratio forced the federal government to cut spending during a recession.

The inequities of high debt

The imperative of lowering the debt-to-GDP ratio is not only a matter of economics and fiscal accounting, however. It is also a matter of fairness towards future generations of Canadians and the legacy left to them.

Canada will face major demographic changes in the next century. Within forty years, the share of the population over 65 will almost double from its current level of 12 per cent to 23 per cent. There will be three workers to support every retired person, compared to five now. Adjusting to these changes alone will pose a considerable challenge. The additional challenge of coming to grips with the current debt load should not be imposed on future generations as well. Those working now should not leave an enormous debt for their children and grandchildren to pay.

The Need for a Sustained Reduction in the Debt-to-GDP Ratio

Ongoing deficit financing has not worked in the past

The lesson of the past 20 years of fiscal policy is, clearly, that ongoing deficit financing eventually becomes unsustainable. In virtually all of these years the federal government pursued a stated objective of balancing its budget at some time in the future, based largely on the hope that it could grow out of its deficit. However, even after adjusting for the impact of cyclical factors, persistent deficits were incurred throughout this period. Such large structural deficits can only be eliminated by discretionary fiscal actions.

Canadians have clearly indicated to their governments that it is time to get back on track – to reduce the federal debt-to-GDP ratio while preserving the essential qualities of Canada's social programs. This requires decisive actions, to reverse the course of federal finances, before mounting debt threatens the country's ability to act on its social commitments.

Sustainable balance in the federal budget is the solution

The only viable solution to the high federal debt-to-GDP ratio is to pursue policies that will *permanently* boost economic growth and *to ensure that the budget remains roughly in balance over the economic cycle.* In periods of economic boom – when the level of activity is straining the economy's capacity to produce – the budget should be in surplus. In periods of economic slack, when unemployment rises and income growth is weak, the federal budget may be in deficit. But, abstracting from the cyclical position of the economy, the budget should be clearly in balance.

The payoff from a lower debt-to-GDP ratio will be large

Reducing the debt-to-GDP ratio and balancing the federal budget over the economic cycle raises the prospect of a substantial payoff. It will lower debt servicing costs, which will make it possible for the government to pursue other interests of strategic importance.

A lower debt-to-GDP ratio will also put downward pressure on interest rates. This will provide additional relief from debt servicing costs. More importantly, it will be a significant stimulus to investment and job creation. Permanently lower interest rates will provide a much greater stimulus to job creation than any government spending program possibly could.

Reducing the debt-to-GDP ratio will lower Canada's international indebtedness and, hence, the share of Canadian income going abroad to service that debt. This will amount to a permanent increase in the standard of living in Canada.

Reducing the debt-to-GDP ratio will also lower the risks to the fiscal situation posed by high interest rates and economic weakness. Indeed, a sustainable balance in the federal budget over the economic cycle opens the possibility of allowing government fiscal balances to play a counter-cyclical role in the economy.

But achieving this balance will not be easy

Interest on the debt is now compounding more rapidly than the economy is growing. In other words, the simple compounding of interest payments is putting upward pressure on the debt-to-GDP ratio.

As a result, the federal government has taken actions in the 1994 and 1995 budgets to bring about increasing operating surpluses – the difference between total revenues and total program spending. The operating surplus is projected to increase to 3.4 per cent of GDP ($27.4 billion) in 1996-97, from 0.6 per cent or $4.6 billion in 1994-95. As a percentage of the economy, the 1996-97 operating surplus will be the largest since the post-war demobilization of the late 1940s and early 1950s. More importantly, this operating surplus will be sufficient to stabilize the debt-to-GDP ratio.

Beyond 1996-97, a sustained operating surplus of 3.4 per cent per year would put the debt-to-GDP ratio on a firm *gradual* downward track. To bring about a larger reduction, the operating surplus will have to rise above 3.4 per cent.

Increasing operating surpluses involve difficult choices. The Auditor General has recently expressed this in the following terms:

> "... Parliament and the public need information to help them understand fully the stark reality that there is a momentum to debt that makes it costly to control the larger it becomes, and consequently more difficult to rein in through just one or two budgets."

To put this in context, consider that maintaining an operating surplus of 5 per cent of GDP for 10 years is required to reduce the federal debt-to-GDP ratio from 73 per cent to about 50 per cent – the level reached in 1985-86.[1] At 5 per cent of a growing economy, the operating surplus in ten years in this scenario would approach $60 billion.

[1] This calculation assumes nominal economic growth of 4 per cent and an average interest rate on the debt of 7.5 per cent.

The Next Milestone for Fiscal Progress

The government's ultimate fiscal objective is a balanced budget. This will ensure that the debt-to-GDP ratio is put on a firm and steady downward track. A key consideration is how fast to move to a balanced budget.

This involves difficult choices. It also requires that the consequences of the choices be fully understood and taken into consideration. Mindless cuts – without concern for the consequences or the need for adaptation – may yield short-term fiscal savings. But they can also result in substantial long-term costs. To achieve a balanced budget and an ongoing reduction in the debt-to-GDP ratio requires a strategy that is measured, thoughtful and responsible.

The government's fiscal strategy has been to implement a significant and persistent, but orderly, reduction in the deficit, based on structural changes in spending. This means allowing departments sufficient lead time to properly plan their program reforms, while fostering adjustment throughout the economy.

The government's deficit reduction strategy has been to focus on a two-year fiscal planning horizon. The two-year horizon recognizes that fiscal projections are simply too sensitive to as yet uncertain economic developments to warrant a longer time frame. But just as importantly, the two year horizon is short enough to maintain the government's focus on actions required to reduce the deficit, while providing sufficient lead time to achieve the targets.

As planning proceeds for the 1996 budget, it is now appropriate to establish a target for the deficit for 1997-98. The government is proposing a deficit target of 2 per cent of GDP.

The deficit target of 2 per cent for 1997-98 also means that the government's financial requirements will be within the range of ½ to 1 per cent of GDP or less than $7 billion. Financial requirements represent the amount the government has to borrow from outside sources. It is less than the deficit to the extent the government is able to borrow from internal sources – principally the public service pension account. By 1997-98, therefore, the government will be close to no longer having to go to credit markets for new borrowings.

5

Meeting the Challenge

The 1994 budget announced $20.4 billion of savings over three years. Actions taken in the 1995 budget totalled an additional $29 billion over three years, including $13.4 billion in 1997-98. Most of the savings in both budgets came from spending reductions rather than tax increases. The unemployment insurance reform proposals recently tabled by the Minister of Human Resources Development will provide for net additional savings of $0.7 billion in 1997-98.

Table 5.1
Budget savings

	1994-95	1995-96	1996-97	1997-98
		(billions of dollars)		
Feb. 1994	1.5	8.0	10.9	11.9
Feb. 1995		5.0	10.6	13.4
UI reform[1]				0.7
Total	1.5	13.0	21.5	26.0

[1] Savings for 1996-97 were included in the 1995 budget measures.

These expenditure reductions are structural. The 1995 budget secured the savings required to meet the 1996-97 deficit target, but the savings *mature*, for the most part, in 1997-98, and *persist* thereafter. Thus the decisions already made in the 1994 and 1995 budgets and the recently announced unemployment insurance reform will ensure that program spending will continue to decline in 1997-98. Simply staying the course on decisions already made will ensure that the deficit falls further in 1997-98, even without further budgetary measures.

As noted in Chapter 4, the government's fiscal strategy has been to implement a significant and persistent, but orderly, reduction in the deficit, based on structural changes in spending. This means allowing departments sufficient lead time to properly plan their program reforms, while fostering adjustment. Budget planning, being undertaken in conjunction with ongoing Program Review, has allowed departments three-years in which to implement program reforms.

The 1995 budget, in announcing Program Review actions to 1997-98, has already contributed to meeting the deficit target now being established for that year. Similarly, the 1996 budget will announce Program Review decisions which will largely affect 1998-99 and subsequent years. This means that the 1996 budget will not only secure the 1997-98 deficit target, but will announce actions that will secure ongoing momentum for deficit reduction past 1997-98.

The government's overall fiscal actions since taking office have been based on a commitment to *fiscal health, social fairness* and ensuring the *sustainability* of Canada's social programs. These principles guided the difficult choices made in the 1994 and 1995 budgets and they will guide the decisions that will be made in the 1996 budget.

Past fiscal choices have also reflected the government's fundamental belief that deficit reduction is not an end in itself, but rather a necessary plank of the jobs and growth strategy.

Getting Government Right: Continuing the Process

The continuing evolution of the role of government

The role of government in Canadian social and economic life has never been static; rather it has changed, at times quite dramatically, in response to the emergence of new national and international challenges.

This era of fiscal restraint – both in Canada and in other countries – provides both a challenge and an opportunity. In order to meet the challenge of permanent fiscal reform, this government has, throughout its mandate, emphasized the importance of government renewal. This is a process to determine the role and priorities for the federal government in the Canadian economy and federation, and to implement reforms to undertake this role in the most efficient and effective manner possible.

It is precisely this priority which inspired the launching, in the 1994 budget, of a series of policy reviews, including the overall Program Review of federal departmental (non-statutory) programs, which formed the cornerstone of the 1995 budget.

The policy actions to date have secured the fiscal savings required to achieve the interim deficit target of 3 per cent of GDP in 1996-97. But they represent a more fundamental change in the vision for how the federal government should be conducting its business.

It is why there has been a focus on the federal government withdrawing from areas better left to the business, the voluntary sector, labour groups, or other levels of government. It is why future reforms to government programs will continue to focus on improving the functioning of markets – for products and services and for labour – thereby ensuring sustained growth and job creation.

Program review principles

The guidelines for assessing the role of government programs and policies were outlined in October 1994 in *Agenda Jobs and Growth: Creating a Healthy Fiscal Climate*. They have not changed.

- **Public interest test:** does the program area or activity serve a public interest?

- **Role of government test:** is there a legitimate and necessary role for government in the area or activity?

- **Federalism test:** is there a role for the federal government in the program area?

- **Partnership test:** what activities or programs should or could be transferred in whole or in part to the private or voluntary sector?

- **Efficiency test:** if the program is to continue, how could its efficiency be improved?

- **Affordability test:** is the program affordable in light of the current fiscal situation?

The results of this assessment formed the cornerstone of the 1995 budget, and the process is ongoing.

Changing what the federal government does

The 1995 budget announced two major changes to the focus of government activities, which cut across all federal departments.

First, the federal government is moving away from the direct ownership or provision of services, where these can better be provided by the private sector or by other agents, or in partnerships with these groups if appropriate.

The government announced the privatization and commercialization of a number of activities formerly undertaken by government departments. This year has seen the recent successful high-profile privatizations of *Petro Canada* and *Canadian National Railway*. In addition, the government is now engaged in privatizing the *Air Navigation System*. But all departments are looking at commercialization opportunities, including moving some activities to Special Operating Status, where activities operate basically on a commercial basis (such as geomatic activities in Natural Resources). Other commercialization opportunities announced in the 1995 budget include recreational harbours and some meteorological activities.

Second, the 1995 budget announced a 60 per cent decline in business subsidies. In the agriculture sector, for example, transportation subsidies are bring eliminated, and farm safety net programs are being focused on a "whole farm" approach rather than being product-specific. Notably, federal involvement in mega projects will also end.

The change in federal program orientation has also meant a fundamental change in federal government activities in regional development. The federal government is moving away from the direct provision of subsidies and other programming through its Regional Agencies. Regional Agencies will instead facilitate the access of small business to private sector financing and provide single points of contact in the different regions for federal programming aimed at the small business sector. Further, regional development agreements in mining and forestry are bring discontinued.

Streamlining and consolidating programs

In almost all departments, actions have been taken to restructure programs and services within smaller budgets. A major example is the creation of the *Human Resources Investment Fund*, which consolidates a myriad of labour market programs under a single umbrella, ensuring more effective use of government resources and supporting better employment opportunities for Canadians.

Reforming program delivery

Federal departments have instituted a number of new options for service or program delivery, which are aimed at increased effectiveness and efficiency, while delivering substantial fiscal savings. In many cases this means new partnerships with the private sector, other levels of government or both. Examples are numerous.

For instance, new partnerships are being developed with provinces and community groups for the delivery of settlement services for new immigrants. First steps in this new type of partnership have already been put in place with the government of British Columbia.

Another example is the new *Service Delivery Network* in Human Resources Development Canada, where clients can more easily access HRDC's programs through a variety of informal means.

In the agriculture and agri-food sector, existing and new initiatives in trade and market development are being integrated into a single-window approach, providing a single point of contact for the sector in the provinces. Inspection and regulation services in this sector are being streamlined, and responsibility will be shared with the agri-food industry.

Reforms announced in the 1995 budget have not only been undertaken for departmental programs, but also for some transfers. The introduction of the new block-funded Canada Health and Social Transfer (CHST) in the 1995 budget ended cost-sharing rules with the provinces, allowing provinces more scope to allocate resources to areas of highest priority within their jurisdictions.

Reducing overlap and duplication

As a result of Program Review, departments have already moved to eliminate overlap and duplication with other levels of government. For example, airport operations are being transferred to municipalities. But other departments have been involved as well.

Efforts to reduce overlap and duplication have also involved efforts to harmonize joint programs with the provinces and territories. For instance, federal and provincial student assistance programs have been harmonized. With respect to Yukon forestry, the Department of Indian Affairs and Northern Development has updated regulations to be more in line with those of the provinces, as well as establishing a reforestation program to be paid for by harvesters.

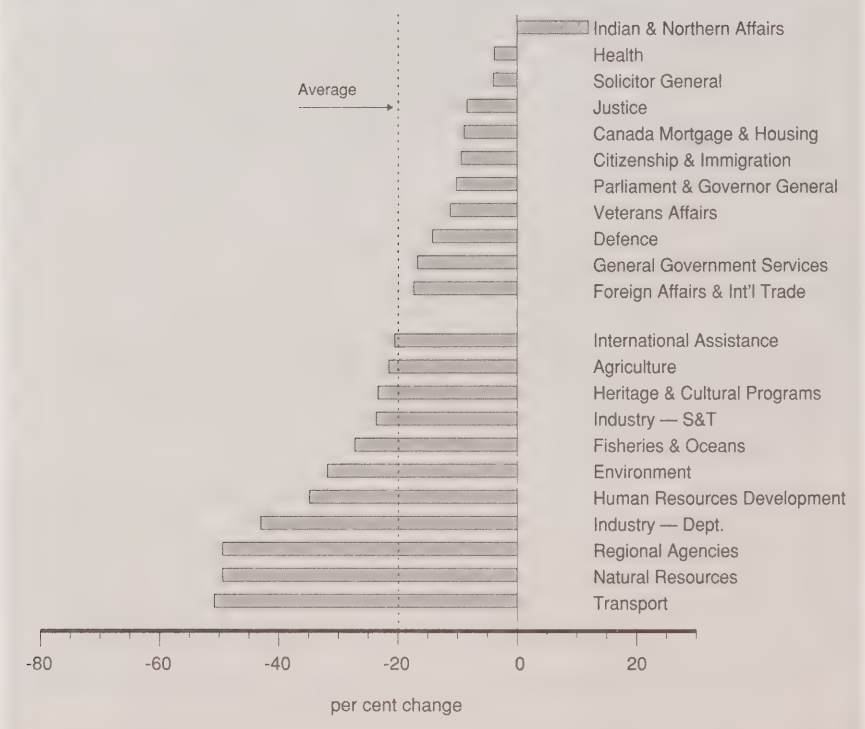
Increasing efficiency through better management

Departments all across the government have announced plans to rationalise their operations – including joint operations – and to assure administrative efficiencies. The most notable reform is the introduction of the new *Expenditure Management System*, to ensure that the scrutiny of government spending undertaken in Program Review becomes a permanent feature of federal government management.

Getting Government Right Means Permanent Fiscal Savings

As a result of these and other actions, Program Review has reduced federal government spending considerably (Chart 5.1). Even without further budgetary action, the 1995 budget announced that by 1997-98 departmental spending will be almost 19 per cent lower than in 1994-95. This

Chart 5.1 Changes in federal department spending 1997-98 relative to 1994-95



will put total departmental spending, in nominal dollars, back to its 1985-86 level. And as a share of the economy, departmental spending will be much lower than at any other time in the past 30 years (Charts 5.2 and 5.3).

The implementation of Program Review I therefore has allowed the government to achieve many of its economic and social objectives. However, there remains unfinished business. These issues are currently being addressed in Program Review II.

The government will continue to assess its role in the economy and federation, including identifying how federal government activities can best be restructured to continue the process of government renewal. Such decisions will guide actions taken in the 1996 budget.

Chart 5.2 Total departmental spending

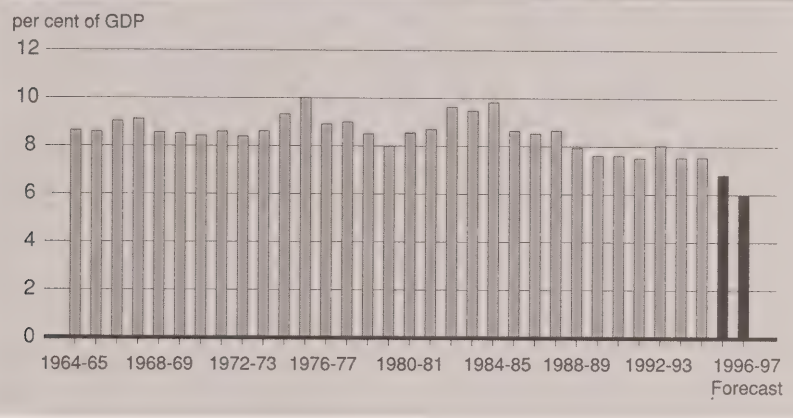
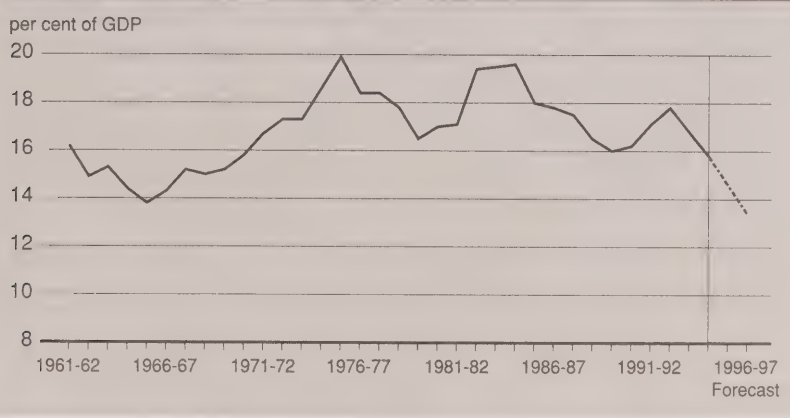


Chart 5.3 Program spending



6

Conclusions and Main Issues

The government's main priority is to create more and better jobs and sustained economic growth. All of the government's economic policy actions will continue to support this goal.

The government has always understood that returning Canada to fiscal health is a prerequisite to realizing the economic strategy. Debt that has grown faster than the economy has led to higher taxes, higher real interest rates, increased uncertainty, and a diminished government capacity to address other issues of strategic importance.

The 1994 and 1995 budgets made substantial progress in putting the deficit on a strong downward path. These actions assured that the 1996-97 deficit target of 3 per cent of GDP will be met.

But there is still more to be done. There is simply too much at risk to avoid taking the additional steps necessary to meet the 1997-98 deficit target. That step will put the debt-to-GDP ratio on a firm downward track. Ultimately, a balanced budget will ensure that the debt-to-GDP ratio falls rapidly to a point at which the country's debt will be consistent with our ability to pay for it.

The decisions taken in the 1995 Budget were consistent with messages clearly and strongly delivered in the process of consultations undertaken last year as part of a new open budget process. As last year, the Finance Committee will be asked to advise on:

1) Are the updated economic assumptions for 1995 and 1996 prudent – particularly with respect to interest rates and nominal income – and what should the economic assumptions for these two variables be for 1997?

2) What should be the ratio between expenditure reductions and revenue increase?

3) To meet the deficit target of reducing the deficit to 2 per cent of GDP, should programs be reduced or eliminated? If so, which ones?

4) Are there specific ways the government could alter its spending and taxation which would increase jobs and lead to stronger, sustained economic growth?

Annex 1

Where the Government Spends

This section provides details on government spending. The government spent $160.8 billion in 1994-95. Twenty six per cent of that spending was for interest payments on the debt. This the government has to pay. Interest payments on the debt accounted for 34 cents of every revenue dollar the government collected in 1994-95.

Annex Table 1
Structure of spending: 1994-95

	Billions of dollars	Per cent of total
Total spending	160.8	100.0
Interest on debt	42.0	26.2
Program spending	118.7	73.8

Program spending in 1994-95 was $118.7 billion (Table 2). Major transfers to persons totaled $36.7 billion. Cash transfers to other levels of government amounted to $26.7 billion. Total transfers to persons and other levels of government in 1994-95 were over $63 billion. Program spending other than major transfers consisted of: subsidies and other transfers ($18.6 billion); payments to crown corporations ($5.0 billion); defence spending ($10.7 billion) and other program spending ($21.0 billion).

In 1992-93, program spending totaled $122.6 billion. It fell to $120.0 billion in 1993-94 and to $118.7 billion in 1994-95. With the actions taken in the 1994 and 1995 budgets, it is projected to continue to

fall in each of the next two years. By 1996-97, program spending is expected to amount to only $108.6 billion, $14 billion less than the level in 1992-93 and $10.1 billion below the level for 1994-95.

Annex Table 2
Program spending

	1994-95	1995-96	1996-97
	(billions of dollars)		
Total program spending	118.7	113.7	108.6
Major transfers to persons			
Elderly benefits	20.5	21.3	21.9
Unemployment insurance	14.8	13.6	14.1
Veterans' pensions/allowances	1.4	1.5	1.4
Total	36.7	36.4	37.4
Major transfers to other levels of government[1]			
EPF/CAP – CHST	17.4	16.7	13.0
Fiscal transfers[2]	9.3	9.8	10.0
Total	26.7	26.5	23.0
Subsidies and other transfers			
Business subsidies	3.7	2.8	1.9
Indians and Inuit	3.7	4.0	4.1
International assistance	2.9	2.2	2.2
Canada Infrastructure Works	0.4	0.9	0.3
Other transfers and subsidies	7.9	5.7	5.2
Total	18.6	15.6	13.7
Crown corporations			
Canadian Broadcasting Corporation	1.1	1.1	1.1
Canada Mortgage and Housing Corporation	2.0	2.0	2.0
Other	1.9	1.4	1.1
Total	5.0	4.5	4.2
Defence	10.7	10.3	9.8
All other spending	21.0	20.4	20.5

[1] Transfers under EPF/CAP – CHST to other levels of government are made as a combination of cash and a transfer of tax points. Total transfers, including cash and tax transfers, were an estimated $38.7 billion in 1995-96.

[2] Includes Equalization, Stabilization payments, PUITTA, Territorial Formula Financing, Youth Allowances Recovery, statutory subsidies and grants in lieu of taxes.

This reduction is the result of the most far-reaching reform of federal program activity since post-war demobilization 50 years ago. The 1995 budget announced actions which will result in cumulative savings of $29 billion (Table 3). These savings will come overwhelmingly from expenditure reductions, with expenditure cuts exceeding revenue increases by a ratio of nearly seven to one over three years. The decline in program spending comes mainly from lower departmental spending, and somewhat from lower transfers to other levels of government. Transfers to persons will increase slightly, as a result of increasing transfers to the elderly.

Annex Table 3
Budget savings

	1994-95	1995-96	1996-97
		(billions of dollars)	
February 1994	1.5	8.0	10.9
February 1995		5.0	10.6
UI reform[1]			
Total	1.5	13.0	21.5

[1] Savings for 1996-97 were included in the 1995 budget measures.

The cornerstone of the actions taken in the 1995 budget was Program Review I, conducted during the fall and winter of 1994.[1] This departmentally driven review of federal government responsibilities and spending programs will lead to long-lasting structural changes in federal government spending. Its key objective was to promote jobs and growth by more clearly defining the federal role in various program areas in relation to the private and voluntary sectors and other levels of government, and by determining the most effective and cost-efficient way of providing remaining federal programs and services to Canadians. The budget also announced a new Expenditure Management System, which, by formalizing the process of resource allocation from lower to higher priorities, ensures that the scrutiny of programs undertaken in Program Review becomes a permanent feature of federal financial management.

[1] In its efforts to continue to reform goverment spending, the government launched this fall a second phase of the review of departmental spending called Program Review II.

The Program Review underlay the government's overall fiscal strategy of a significant and persistent, but orderly, reduction in the deficit, based on structural changes in spending that will make savings permanent. Departments have been allowed sufficient lead time to properly plan their program reforms, while fostering adjustment throughout the economy. Thus, this year's budget announced Program Review decisions to 1997-98, although savings will persist beyond that date. These savings will thus contribute to the attainment of the 1997-98 deficit target. Program Review decisions underlying the 1996 budget will thus focus mainly on 1998-99, with savings persisting, as well, into the future.

Departments have used six tests to determine their departmental spending priorities and program design: serving the public interest; necessity of government involvement; appropriate federal role; potential for public sector/private sector partnerships; scope for increased efficiency; and affordability. The 1995 budget announced that, as a result of last year's Program Review I, departmental spending will be cut by $3.9 billion in 1995-96, $5.9 billion in 1996-97 and $7.2 billion in 1997-98 relative to what would have been the case otherwise. By 1997-98, departmental spending will be 18.9 per cent lower due to actions taken in last year's Program Review I.

Significant shifts in the pattern of departmental spending are occurring as a result of Program Review (Table 4). The share of spending by economic and resource departments is shrinking, reflecting the government's decision to move away from the direct ownership or provision of services, where these can better be provided by the private sector or by other agents.

Spending by social departments, Justice and Corrections and Defence are rising. The significant rise in social departmental spending (i.e. excluding transfers such as unemployment insurance) is due, in large part, to the increasing resources being devoted by the government to Aboriginal spending.

The remainder of this Annex provides detailed information on federal spending patterns for the fiscal years 1994-95 through 1996-97. For 1994-95, the figures shown are consistent with the *Public Accounts of Canada*. The 1995-96 figures are generally based on the *Main Estimates* for 1995-96, but are adjusted for supplementary estimates and decisions which have been

taken since their tabling last February. Figures for 1996-97 are only available on an aggregate basis at this time and will be revised and shown on a more disaggregated basis with the release of the 1996-97 *Main Estimates*. This is consistent with the presentation in the October 1994 *Economic and Fiscal Update*.

Annex Table 4
Evolution of departmental spending

	1984-85	1994-95	1996-97
	(per cent of total)		
Economic programs	34.2	22.4	17.9
Natural Resource Sector	18.9	10.4	8.3
Transportation	8.8	5.3	3.4
Industry/Regional/S&T	6.5	6.7	6.2
Social programs	19.5	25.0	28.2
Aboriginal	5.7	9.4	12.1
Heritage and Culture	5.8	5.5	5.5
Justice and Corrections	4.5	6.4	7.1
Foreign Affairs and Int'l Trade Assistance	6.0	8.3	7.7
Defence	21.2	22.3	23.0
General Government Services	8.9	10.1	10.6
Total[1]	100.0	100.0	100.0

[1] Components may not add to total due to rounding.

Departmental Spending

Natural Resource-Based Programs

Federal spending on natural resource-based programs applies to agriculture, energy, mines, forestry, fisheries and the environment.

Total spending in 1994-95 was $5 billion, and is expected to be $3.8 billion in 1996-97. Nearly 50 per cent will be in the form of transfers, primarily to the agricultural sector. Spending on operations in this sector is largely directed to a wide range of scientific and technological research and inspection services.

The overall objective is to support the orderly development of natural resources in ways that maximize economic benefits to Canadians while ensuring that the quality of the environment is protected and enhanced.

Annex Table 5
Natural resource-based programs

	1994-95	1995-96	1996-97
		(millions of dollars)	
Agriculture	2,080	1,928	1,762
Natural Resources	1,423	1,145	757
Fisheries and Oceans	778	897	653
Environment	716	664	550
Total	4,997	4,634	3,772

Agriculture

Agriculture and Agri-Food Canada programming focuses on the following areas: farm income stabilization, grains policy and transportation, supply management, inspection and quarantine, research, trade and market development, environmental sustainability, adaptation and rural development, as well as policy and economic analysis.

A core aim of the department is encouraging the Agriculture and Agri-food industry to increasingly provide its own financial security in the event of income fluctuations. This financial security will help stabilize farm incomes while promoting increased efficiency in production. The department is promoting the transition to higher value-added and technologically sophisticated production through the development of new mechanisms for providing access to capital investment. Mechanisms are being implemented to bolster export market development.

As a result of last year's Program Review I, the 1995 budget announced that the farm safety net system will move to a "whole farm" support, from the traditional emphasis on support of individual commodities. In addition, the 1995 budget terminated the Western Grain Transportation Act as well as the Feed Freight Assistance transportation subsidy. Federal resources devoted to inspection and regulations were also reduced, helping to reduce overlap with the provinces and share the costs of these programs with industry.

Annex Table 6
Agriculture

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfer payments			
Farm Income Protection Act			
Crop Insurance	162	180	
GRIP	400	200	
NISA	163	245	
Other	20	69	
Dairy	227	208	
Other	259	196	
Total	1,231	1,098	
Operating and capital	847	827	
Canadian Dairy Commission	3	3	
Total[1]	2,080	1,928	1,762

[1] Excludes the Western Grain Transportation Act.

Natural Resources

The Department of Natural Resources emphasizes mining, forestry and energy policy to promote sustainable development and international competitiveness of resource sectors. The department places particular emphasis on cooperation with provinces and partnerships with industry in R&D, technology development and diffusion, and policy emphasis on energy efficiency and alternative energy sources. The Minister of Natural Resources is also responsible for Atomic Energy of Canada Ltd., the Crown Corporation which researches and develops nuclear technology, as well as three regulatory agencies: the Atomic Energy Control Board, the National Energy Board, and the National Pipeline Agency.

As a result of last year's Program Review I, the Department will keep a presence in forestry, mining and other energy sectors, but it has discontinued the direct support for megaprojects, federal-provincial forestry and

mineral agreements and traditional resource development activities. A significant initiative towards reducing the federal government's direct involvement in the resource sector, was the recent successful privatization of Petro-Canada.

Annex Table 7
Natural Resources

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfer payments			
Hibernia project	330	172	
Interprovincial Pipeline	6	26	
Provincial revenue agreements	5	29	
Forestry	98	70	
Other	174	51	
Total	613	348	
Operating and capital	562	550	
Atomic Energy of Canada Ltd.	180	173	
Atomic Energy Control Board	41	44	
National Energy Board	27	30	
Total	1,423	1,145	757

Fisheries and Oceans

The Department of Fisheries and Oceans (DFO) is the lead department through which the Government of Canada exercises its jurisdiction over Canada's freshwater and oceans resources, and fulfills its responsibilities to ensure that they are managed in a viable and sustainable manner. These resources include those of the sea bed and the subsoil of the Continental shelf.

Significant developments over the past year have resulted in a fundamental reshaping of the role and activities of DFO. On April 1, 1995, DFO merged with the Canadian Coast Guard, consolidating the Government's main civilian marine assets and operational programs into one strengthened department. DFO is now reoriented to perform as the Government's principal agent for the fulfillment of its responsibilities with regard to oceans and major inland waterways.

The Department is also undergoing major reductions as a result of last year's Program Review I: there will be a significant decline in departmental spending over the three years 1995-96 through 1997-98. Six major business

lines have been established to achieve its vision of being a world leader in oceans and marine resource management:

- understanding the oceans;
- manage and protect the fisheries resource;
- manage and protect the marine environment;
- maintain ship safety;
- facilitate marine trade, commerce and ocean development; and
- advance Canada's international fisheries and oceans interests.

The major thrusts to meet its Program Review I targets and achieve the fulfillment of its business lines include: devolution of responsibilities to the provinces, the development of government-industry partnerships, and the implementation of comprehensive organizational streamlining.

Annex Table 8
Fisheries and Oceans

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfer payments			
Special Groundfish Programming			
NCARP License			
Retirement Program	105	11	
Atlantic Groundfish			
Strategy (TAGS)	0	196	
Aboriginal Fisheries			
Strategy (AFS)	0	28	
Other	2	10	
Total	107	245	
Operating and capital	671	652	
Total spending[1]	778	897	653

[1] Total spending excludes the transfer of resources from Transport Canada to Fisheries and Oceans for Canadian Coast Guard and Corporate Services (approximately $545 million in 1995-96 and $547 million in 1996-97).

Environment

Programs under Environment Canada include: reducing risks to the environment and human health caused by human activities, minimizing the danger to life and property from severe weather and other environmental hazards and encouraging sustainable development. Other priorities include contributing to a competitive economy by focusing on providing international and national leadership on key environmental issues. The Department's funding amounted to $664 million in 1995-96.

Federal spending on environmental-related programs also takes place under other departments. For example, Environment Canada only manages 35 per cent of spending under the Green Plan.

Decisions made in last year's Program Review I were intended to streamline and modernize its activities at the community level while sustaining the department's science, policy and enforcement capabilities as the foundations of its leadership.

Annex Table 9
Environment

	1994-95	1995-96	1996-97
		(millions of dollars)	
Transfer payments	72	55	
Operating and capital	644	608	
Total	716	664	550

Transport

The federal government supports transport primarily through programs of Transport Canada and the National Transportation Agency.

Transport Canada sets the regulatory and policy framework for all transportation sectors, through legislation/regulation development, compliance (inspection and testing), certification, licensing and education programs relating to transportation safety, security and environmental protection in the marine, aviation, rail, and motor vehicle modes. Transport Canada is moving away from being a direct provider of services to being a policy maker and regulator. It will, however, continue to ensure reasonable service to remote communities and for Canadians with disabilities.

Annex Table 10

Transport

	1994-95	1995-96	1996-97
	(millions of dollars)		
Department			
Transfer payments			
Ferry and coastal service	64	51	
Strategic Capital Investment Initiative	132	114	
Highway agreements[1]	84	93	
Municipal airports	12	12	
Rail crossing improvements	8	8	
Payment to Canada Wheat Board	19	15	
VIA Rail	301	288	
Marine Atlantic	112	107	
Airports	9	30	
Other	11	42	
Total	752	760	
Operating and capital			
Gross[2]	2,225	2,176	
Revenues	(1,002)	(1,079)	
Net operating	1,223	1,097	
Total	1,974	1,857	1,547
National Transportation Agency			
Transfers			
Western Grain Transportation Act	644	210	
National Transportation Act	17	10	
Atlantic Region Freight Assistance Act	98	40	
Maritime Freight Rates Act	9	3	
Railway Act	10	8	
Total[3]	778	271	
Operating and capital	32	32	
Total National Transportation Agency	810	303	
Other Agencies			
Civil Aviation Tribunal	1	1	
Grain Transportation Agency Administrator	13	8	
Total	2,798	2,169	1,579

[1] Includes ERDAs, Nfld. regional trunk, TransCanada, Fixed Link and P.E.I. co-op.

[2] Operating figures include amounts for Crown Corporations (Jacques Cartier and Champlain Bridges, Canada Ports Corporation, Atlantic Pilotage Authority, Laurentian Pilotage Authority and St. Lawrence Seaway Authority).

[3] Figures do not reflect impending transfer of Canadian Coast Guard to the Department of Fisheries and Oceans.

As determined in Program Review I, and announced in the 1995 budget, Transport Canada reduced or eliminated most transportation subsidies, including subsidy programs for grain farmers (in conjunction with Agriculture Canada) under the Western Grain Transportation Act and for transportation companies under the Atlantic and Maritime Region Freight Assistance Acts.

Transport Canada is commercializing many of its current operations, including the transfer of airports to local authorities and the commercialization of the Air Navigation System. In addition, Transport Canada is privatizing Canadian National Railways.

Transport Canada also integrated its Coast Guard operations with the fleet of the Department of Fisheries and Oceans, and introduced various cost-recovery measures and increased existing fees to balance operating costs and revenues. For example, en route air navigation services to aircraft that traverse Canadian airspace will be cost-recovered. Over one-third of Transport Canada's total expenditures (including subsidies) are recovered through user fees.

Industrial, Regional and Scientific-Technological Support Programs

These programs are designed to foster regional and industrial development and to enhance Canadian industrial competitiveness by stimulating private sector investment across Canada. Industry Canada supports programs to promote international competitiveness, increased investment in Canada, regional development in northern Ontario, and to assist aboriginal people to realize their economic potential. The regional development agencies – Atlantic Canada Opportunities Agency, Federal Office of Regional Development in Quebec, and the Department of Western Economic Diversification and Industry Canada for FedNor – support the development of each region's economic potential, deliver assistance programs to entrepreneurs and small businesses, ensure the fair access of regional businesses to federal programs and services and procurement opportunities, and ensure that federal policies and programs are sensitive to regional concerns. ACOA also includes the Enterprise Cape Breton Corporation.

Annex Table 11

Industrial, Regional, and Scientific-Technological Support Programs

	1994-95	1995-96	1996-97
	(millions of dollars)		
Industry Department			
Transfer payments[1]			
Defence Industry Productivity Program	141	102	
Aboriginal Economic Program	56	42	
Canada Scholarships Program	21	23	
Sector Campaigns	30	21	
Strategic Technologies	19	22	
Other	290	203	
Total	557	413	
Gross operating and capital	586	668	
Revenues Credited to Vote	(52)	(60)	
Total net operating and capital	534	608	
Total Industry Department	1,091	1,021	748
Regional Agencies[1]			
Atlantic Canada Opportunities Agency	289	281	
Federal Office of Regional Development Quebec	175	230	
Western Economic Diversification	155	216	
Enterprise Cape Breton Corporation	16	18	
Total	635	745	630
Other Programs/Boards/Agencies and Councils			
Canada Infrastructure Works Program	415	931	293
Cape Breton Development Corporation	25	–	
Competition Tribunal	1	1	1
Copyright Board	1	1	1
Standards Council of Canada	5	5	5
Business Development Bank of Canada	14	14	14
Canadian Space Agency	318	302	212
National Research Council	448	413	382
Natural Sciences and Engineering Research Council	493	470	450
Social Sciences and Humanities Research Council	101	100	91
Total	1,821	2,237	1,449
Total	3,547	4,003	2,827

[1] Excludes funding for Canada Infrastructure Works Program, which is shown separately.

The National Research Council and the three Granting Councils (MRC, SSHRC and NSERC) support a wide range of science and technology activities.

Following Program Review I, regional industrial programming and service delivery were rationalized to reduce overlap and duplication among Industry Canada and the regional agencies. Federal industrial and business development programs will progressively be consolidated in a single point of contact. As well, departments and agencies moved away from providing business subsidies to assisting small business in obtaining access to commercial financing .

Transfer payments constitute about two-thirds of spending on Industrial, Regional and Scientific-Technological Support Programs including contributions under the Canada Infrastructure Works Program (shown separately), contributions to businesses under the Defence Industry Productivity Program, and contributions under the Aboriginal Economic Program.

Justice and Legal Programs

Programs in this sector provide for the administration of justice and law enforcement. They support a fair and equitable justice system and maintain law and order through policing and custodial activities.

The Department of Justice provides a range of services to the Government of Canada including legislative drafting, legal advice, recommendations and opinions as well as representation in the enforcement of federal law in litigation matters involving the federal government. The department is also responsible for managing the development, testing, promotion and implementation of justice policy, and ensures fair, effective and responsible public administration by managing the government legal framework. The portfolio also includes the Supreme Court, the Federal and Tax Courts of Canada, the Canadian Human Rights Commission, and the Offices of the Commissioners for Federal Judicial Affairs, Information, and Privacy.

As a result of last year's Program Review I, the Department of Justice will be focusing its activity on helping to modernize and simplify the justice system, including sentencing reform in order to reduce incarceration rates, and on implementing existing commitments such as firearms legislation and its part of the government's Safe Home/Safe Streets agenda. Further efficiencies are to be achieved through the restructuring of federal-provincial cost-sharing agreements under the Criminal Legal Aid and Young Offender Program agreements. The Department will also continue to examine ways of controlling the rising cost of the justice system.

Annex Table 12
Justice and Legal Programs

	1994-95	1995-96	1996-97
		(millions of dollars)	
Justice			
Transfer payments			
Young Offenders Act	156	156	
Legal aid	90	88	
Other	31	21	
Total	276	265	
Operating and capital	199	194	
Total Justice	475	458	426
Solicitor General			
Transfer payments			
Indian Policy Program	28	48	
Other (including RCMP, CSC)	43	45	
Total	71	93	
Operating and capital			
Correctional Service Canada	1,039	1,098	
RCMP	1,242	1,167	
Department	34	24	
Total	2,315	2,289	
Total Solicitor General	2,386	2,382	2,341
Federal Judicial Affairs	201	210	216
Supreme Court of Canada	15	16	14
Federal Court of Canada	28	31	30
Tax Court of Canada	10	11	11
Office of Information and Privacy Commissioners	7	6	6
Canadian Human Rights Commission	17	17	16
Canadian Security Intelligence Service	206	187	166
National Parole Board	25	26	24
RCMP External Review Commission	1	1	1
RCMP Public Complaints Commission	4	4	4
Office of Correctional Investigator	1	1	1
Total	3,376	3,351	3,256

The Solicitor General has responsibility for the federal corrections, policing and national security. Eight organizations report to Parliament through the Solicitor General, including the department, the RCMP, Correctional Service Canada, the National Parole Board, CSIS, and three small review agencies.

Ministry priorities include the advancement of the government's Safe Home/Safe Streets agenda, sentencing reform, and the development of new policy measures to deal with high-risk, violent offenders. Sentencing and corrections reform will be aimed at containing the rate of growth of the inmate population and associated correctional costs. Other initiatives being advanced include community policing and expanded crime prevention, intensified efforts to combat organized crime and effective and efficient law enforcement.

Heritage and Cultural Programs

Canadian Heritage promotes the development of Canada's culture, including public broadcasting, a strong sense of Canadian identity based on shared values and goals through citizen participation and multi-cultural programs, official languages support, amateur sport and the preservation of parks and historical sites.

Annex Table 13
Heritage and Cultural Programs

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfers			
Canadian Broadcasting Corporation	1,094	1,121	
Canadian Film Development Corporation	122	110	
National Film Board	85	76	
Canada Council	98	96	
National Museums	134	125	
National Arts Centre	22	19	
National Capital Commission	101	83	
National Archives	58	61	
National Library	37	34	
Advisory Council – Status of Women	3	3	
Status of Women – Office of Coordinator	5	15	
Official Languages	302	255	
Amateur sports	69	57	
Postal subsidy	78	69	
Other	172	134	
Total	2,380	2,258	2,040
Parks Canada	343	349	308
National Battlefields Commission	5	5	2
Canadian Radio-television and Telecommunication Commission	22	21	20
Operating and capital	157	138	134
Total	2,906	2,771	2,505

With fewer financial resources available to support its activities, the portfolio will have to balance financial and policy imperatives. Canadian Heritage is committed to pursuing initiatives to restructure and streamline its activities, to make better use of technology, to develop innovative mechanisms of co-operation with its partners, and to use a more entrepreneurial approach.

Foreign Affairs, International Trade, and International Assistance

The purpose of this program is to carry out Canada's foreign policies, represent Canada's interests abroad, and provide assistance to developing countries.

These programs are carried out by the Department of Foreign Affairs and International Trade (FAIT), the Canadian International Development Agency (CIDA), the Department of Finance, and other agencies such as the International Development Research Centre (IDRC).

Foreign Affairs and International Trade Canada's (FAIT) primary responsibilities include promoting Canadian exports and encouraging foreign investment in Canada, protecting Canada's international security interests, projecting Canadian culture and values abroad, and defending Canada's interest in a rules-based international trading system. The department also provides consular assistance to Canadians traveling or living abroad.

The core priority of the International Assistance Envelope (IAE) is the maintenance of a comprehensive aid program, which maintains Canada's presence and programs in needy regions of the world. The largest part of this funding is managed by the Canadian International Development Agency (CIDA). This program provides bilateral and multilateral aid, food, special development programs and international emergency relief.

Through the Foreign Policy Review and last year's Program Review I, IAE expenditures are to focus on core roles through reduced administrative costs and overhead, reduced program activities, and over time, lower contributions to international financial institutions to a level that balances Canada's international interests with fiscal capability.

Annex Table 14
Foreign Affairs and International Assistance

	1994-95	1995-96	1996-97
	(millions of dollars)		
Foreign Affairs			
Transfers	349	336	
Operating and capital	938	966	
Total	1,287	1,302	1,142
International Assistance			
Transfers			
CIDA Partnership Programs	671	495	
CIDA National Initiatives	994	959	
Countries in transition	–	116	
International Financial Organizations (CIDA)	336	141	
International Financial Organizations (Finance)	486	249	
Loan repayments	(60)	(60)	
Other[1]	233	125	
Total	2,660	2,024	
Operating and capital	153	105	
International Development Research Centre	112	96	
Total	2,925	2,225	2,220
Other Repayments	2	10	0
Agencies			
NAFTA Secretariat	2	2	2
International Joint Commission	4	5	4
Export Development Corporation	152	148	135
Total	4,372	3,692	3,503

[1] Figure includes international assistance grants and contributions made by Foreign Affairs, scholarship program, and administrative costs related to Foreign Affairs programs under international assistance envelope.

Social Programs

Federal *departmental* spending on social programs applies to immigration, health, labour market programs, aboriginal programs, housing and veterans programs. Federal spending on the major statutory social programs (i.e. elderly benefits, unemployment insurance benefits and the CHST) are dealt with below in the sections entitled "Major Transfers to Persons" and "Major Transfers to Other Levels of Government".

Total spending in 1994-95 was $13.2 billion and is expected to be $12.9 billion in 1996-97. Spending on all major programs will decline in the next two fiscal years, save for aboriginal spending. However, the *share* of spending on total social programs in total departmental spending will rise.

Federal social programs meet a number of objectives, including protecting low-income Canadians, facilitating labour market adjustment, safeguarding and promoting the physical health of Canadians and supporting aboriginal Canadians and veterans.

Annex Table 15
Social Programs

	1994-95	1995-96	1996-97
	(millions of dollars)		
Citizenship and Immigration	659	670	665
Health	1,818	1,908	1,854
Human Resources Development	2,983	3,028	2,296
Indian Affairs and Northern Development	3,785	4,078	4,138
Canada Mortgage and Housing Corp.	1,988	2,026	1,968
Veterans' pensions and allowances	1,975	1,998	1,935
Total	13,208	13,708	12,856

Citizenship and Immigration

The Department of Citizenship and Immigration is responsible for promoting the values of Canadian citizenship, for managing immigration, for managing the entry of visitors and temporary workers, for the refugee determination system, for ensuring proper enforcement of the Immigration Act, and for assisting newly arrived immigrants to adapt and settle. The Immigration and Refugee Board of Canada determines refugee claims, hears immigration appeals and adjudicates immigration inquiries and detention reviews.

As a result of last year's Program Review I, the department is reshaping Canada's immigration and citizenship policies to better serve the interest of Canadians by:

- extending the multi-phase user fee strategy to put the program on a secure financial footing with gradual increases to all existing citizenship fees and the introduction of the new Right of Landing and the Right of Citizenship fees;

- achieving a better balance between family and economic immigration, strengthening selection criteria for independent immigrants and redesigning the Business Immigration Program;

- developing new eligibility and financial criteria in order to reduce the incidence of sponsorship default;

- establishing single-member panels to conduct Immigration and Refugee Board hearings and directing resulting savings to help settle refugees from abroad;

- putting in place a new removal strategy with the emphasis on the enforcement of removal/deportation orders; and,

- working with provinces to strike new immigration agreements which will give them more control over immigration selection and to eliminate overlap and duplication in the delivery of settlement services.

These reforms will shift the balance of immigration toward those who exhibit the capacity to settle quickly and contribute to the economy. In addition, reforms should also help relieve the pressure on federal settlement services and provincial social services.

Annex Table 16
Citizenship and Immigration

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfers			
Canada-Quebec Accord	90	90	
Language instruction	91	106	
Adjustment assistance	46	43	
Settlement and adaptation	14	14	
Other	4	3	
Total	245	256	
Operating and capital	337	336	
Total	582	593	589
Immigration and Refugee Board of Canada	77	77	76
Total	659	670	665

Health

Health Canada's role encompasses a broad range of activities aimed at protecting, preserving and improving the health of Canadians, including disease prevention and health promotion. The department administers the Canada Health Act which ensures that all residents of Canada have reasonable access to basic health care services paid for by the public sector. A significant proportion of its activities entails collaboration with provincial and territorial governments.

Health Canada also provides Status Indians and Inuit with health services in areas such as community health, hospital and treatment services and non-insured health benefits.

The Medical Research Council, the Patent Medicine Prices Review Board and the Hazardous Materials Information Review Commission fall under the mandate of the Minister of Health Canada.

Although overall program spending was reduced under last year's Program Review I, some of the savings have been redirected to other priorities. These include:

- the National Forum on Health, which was created to promote a dialogue with Canadians about their health and examine the issues relating to health system renewal;

- enhancements to the capabilities of the federal government to monitor and control disease;

- recognition of women's health issues such as breast cancer research and the establishment of Centres of Excellence for Women's Health;

- the implementation of the Canada Prenatal Nutrition Program; and

- assistance to Aboriginals through implementation of the Aboriginal Head Start Program.

Annex Table 17
Health

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfers			
Indian and Northern Health Services	312	336	
Other	148	192	
Total	460	528	
Operating and capital	1,089	1,124	
Total[1]	1,549	1,652	1,607
Medical Research Council	265	251	242
Patent Medicine Prices Review Board	3	3	3
Hazardous Materials Information Review Commission	1	1	1
Total	1,818	1,908	1,854

[1] These transfers do not include EPF health payments as these are now included in the new Canada Health and Social Transfer.

Human Resources Development Canada

Human Resources Development Canada (HRDC) is responsible for income security programs for the elderly, the disabled, the unemployed and families with children, for student loans, for labour market adjustment programs to develop and support the use of Canada's human resources. It provides funds to the provinces for social assistance and services, for post-secondary education, and for vocational rehabilitation of persons with disabilities. It also facilitates and sustains stable industrial relations and a safe, fair and equitable workplace.

Excluding the major transfer programs, which are discussed separately, and operating costs, the department will streamline and restructure its programs and services into a unified Human Resources Investment Fund which will focus on actively helping unemployed people find and keep jobs, combating child poverty and providing assistance to those who need help most. A portion of savings from unemployment insurance reform will be combined with funds previously committed to these purposes. Decision making will be pushed down to the local level and service delivery will better reflect community priorities.

Annex Table 18
Human Resources Development

	1994-95	1995-96	1996-97
		(millions of dollars)	
Transfers			
Employment programs	1,115	903	
Atlantic Groundfish Strategy	316	414	
Labour adjustment benefits	37	25	
Workers' Compensation benefits	60	48	
Vocational Rehabilitation of Disabled Persons	201	189	
Canada Student Loans	529	521	
Children's Special Allowance	39	43	
Strategic Initiatives	24	115	
Older Worker Adjustment	60	46	
Other	156	82	
Total	2,537	2,386	1,830
Operating and capital	434	631	455
Total	2,971	3,017	2,285
Canada Labour Board	9	9	9
Canadian Centre for Occupational Health and Safety	3	2	2
Total[1]	2,983	3,028	2,296

[1] HDRC spending is higher than shown in the 1995 budget because it includes transfers under the Canada Student Loans and the Children's Special Allowance programs. These two programs were included as transfers in the 1995 budget, but not as departmental spending.

Aboriginal Programs

Federal funding for Aboriginal people is currently about $5 billion. In addition to the Department of Indian Affairs and Northern Development (DIAND) and the Department of Health, 10 other departments have programs directed to aboriginal people, including Industry Canada and the Canada Mortgage and Housing Corporation.

Last year's Program Review I made no major changes to DIAND's existing mandate, but growth in program spending (excluding land claims, northern programming and other adjustments including post-secondary education) was restricted to 6 per cent in 1995-96 and 3 per cent for the following two years. Growth in the department's spending has averaged over 8 per cent per year over the last decade.

Annex Table 19
Indian Affairs and Northern Development

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfers			
Education	1,000	1,077	
Social Assistance	864	965	
Capital (including housing)	786	856	
Local and self government	309	310	
Claims	302	331	
Economic development	53	51	
Northern Affairs	79	55	
Other	25	62	
Total	3,418	3,707	
Operating and capital	367	371	
Total	3,785	4,078	4,138

Canada Housing and Mortgage Corporation

Through the Canada Mortgage and Housing Corporation (CMHC), the federal government helps Canadians to obtain affordable, adequate and suitable shelter. The bulk of federal transfers to the Corporation is to subsidize the cost of shelter for lower-income families.

Over 90 per cent of CMHC's spending on social housing is used to meet existing subsidy obligations for housing. CMHC is currently working with provinces and others to identify avenues to secure greater efficiencies in the management of the existing housing portfolio.

Annex Table 20
Canada Mortgage and Housing Corporation

	1994-95	1995-96	1996-97
	(millions of dollars)		
Social housing	1,896	1,928	
Other	91	97	
Total	1,988	2,026	1,968

Veterans' Pensions and Allowances

A range of benefits and services are provided to veterans and their dependents, to survivors of veterans and to eligible civilians. They include disability pension benefits, income support, and health care benefits.

Cost pressures in this area primarily relate to health care expenses and the provision of services under the Veterans Independence Program, which provides home support to veterans who might otherwise be institutionalized. Neither the War Veterans' Allowance nor disability benefits are taxable.

Annex Table 21
Veterans' Pensions and Allowances

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfers			
Pensions	1,113	1,139	
Health care	190	188	
Income Support	142	144	
Total	1,445	1,471	1,449
Other Health Purchased Services	320	321	291
Operating and capital	210	206	195
Total	1,975	1,998	1,935

Defence

The *1994 Defence White Paper* called for the preservation of multi-purpose, combat-capable forces to meet Canada's security needs at home and abroad. Greater emphasis will be placed on supporting Canada's peacekeeping efforts. Following the policy mandate set out in the *White Paper*, the Department of National Defence has identified four major capital projects it is currently working on: armored personnel carriers, search and rescue helicopters, maritime helicopters, and conventionally-powered submarines.

The 1995 budget reduced the planned level of defence spending by $2.8 billion between 1994-95 and 1998-99. As a result, defence spending will decline by almost 5 per cent each year through to 1997-98, a decline of more than 14 per cent from 1994-95.

Annex Table 22
Defence/Emergency Preparedness Canada

	1994-95	1995-96	1996-97
		(millions of dollars)	
Defence			
Capital	2,769	2,604	
Operating	7,998	7,484	
Pensions	798	747	
Other	209	175	
Total	11,774	11,010	10,479
Emergency Preparedness Canada	27[1]	68[1]	15

[1] Includes payments under the Disaster Financial Assistance Arrangements.

General Government Services

The departments and agencies that support and coordinate the operation of the federal government are shown in Table 23.

Annex Table 23
General Government Services

	1994-95	1995-96	1996-97
		(millions of dollars)	
Parliament/Governor General[1]	410	366	335
Central Agencies	272	237	196
National Revenue	2,286	2,179	2,073
Public Works and Government Services	1,814	1,783	1,594
Statistics Canada	275	288	406
Canada Post[2]	14	14	14
Canadian Commercial Corporation	13	12	12
Agencies			
Canadian Centre for Management Development	11	11	9
Canadian Intergovernmental Conference Secretariat	3	3	3
Canadian Transportation Accident and Safety Board	26	25	23
Commissioner of Official Languages	12	12	10
Public Service Staff Relations Board	6	6	6
Security Intelligence Review Committee	1	1	1
Public Service Commission	124	128	113
Canadian International Trade Tribunal	8	8	8
Office of the Superintendent of Financial Institutions	1	3	3
Purchase of domestic coinage	48	34	32
Total	5,324	5,110	4,838

[1] Includes Chief Electoral Officer and Auditor General.

[2] Canada Post receives $14 million per year in appropriations to provide free mail services for Parliament and literature for the blind.

Parliament/Governor General

The Parliament of Canada consists of the Senate, the House of Commons and the Library of Parliament. In 1994-95, the cost of operating Parliament was about $305 million, including the salaries of Members, Senators and staff. The budget of the House of Commons is not determined by the government but is solely determined by its Board of Internal Economy. Any options for budgetary savings must be decided upon by the Board.

The Governor General spends about $10 million each year on duties as the representative of the British Monarch in Canada.

The Office of the Chief Electoral Officer provides general direction and supervision over the administrative conduct of federal elections and referendums, while the Auditor General of Canada audits the operations of federal departments, agencies and Crown corporations for the review of the Parliament of Canada. As a result of last year's Program Review I, the Office of the Auditor General improved the efficiency of its support services and reduced the number of value-for-money audits.

Annex Table 24
Parliament

	1994-95	1995-96	1996-97
		(millions of dollars)	
Senate	42	42	41
House of Commons	246	224	217
Library of Parliament	17	16	15
Total	305	282	273
Governor General	11	10	10
Chief Electoral Officer	36	23	4
Auditor General	57	51	49
Total[1]	410	366	335

[1] Components may not add to total due to rounding.

Central Agencies

The Treasury Board is responsible for the general management of the government's financial, human and materiel resources. In addition, it contributes – as the "employer" – to employee health, income maintenance and life insurance plans and makes payments relating to provincial payroll taxes and provincial health insurance plans. As a result of last year's Program Review I, the Treasury Board is focusing its efforts on providing a more efficient management framework for the public service. In particular, it is implementing the government's new Expenditure Management System.

The Department of Finance provides general policy advice on Canada's economic and financial affairs. It is also responsible for administering the Fiscal Transfer Payments Program and the Public Debt Program in co-operation with the Bank of Canada. Actions taken in last year's budget resulted in departmental efficiency improvements and reductions of operations in a number of areas.

The Privy Council Office is responsible for advice and support to the Prime Minister and ensures the smooth operation of the government decision-making process. As a result of the 1995 budget, the Privy Council Office introduced a number of streamlining initiatives to improve the efficiency of its operations.

Annex Table 25
Central Agencies

	1994-95	1995-96	1996-97
		(millions of dollars)	
Treasury Board	88	83	78
Finance	66	71	56
Privy Council Office	118	83	62
Total	272	237	196

National Revenue

The core responsibilities of the Department of National Revenue are to administer Canada's personal and corporate income taxes, excise taxes and duties, and employee and employer contributions to the Canada Pension Plan and the Unemployment Insurance program. It also enforces Canadian laws and sovereignty at the border and is responsible for trade-policy administration.

As a result of actions taken in last year's Program Review I, Revenue Canada implemented improvements in the efficiency of a number of its existing programs. It also has placed greater emphasis on audit and other enforcement activities.

Annex Table 26
National Revenue

	1994-95	1995-96	1996-97
		(millions of dollars)	
National Revenue	2,286	2,179	2,073

Public Works and Government Services

Public Works and Government Services Canada (PWGSC) provides central and common services to the federal government. These services range from real property management and procurement of goods and services to auditing, banking, cash management and the provision of translation services. The department is concentrating on improving its services to business, through building partnerships with the private sector and reducing small business paper burden.

As a result of last year's Program Review I, the department is pursuing alternative mechanisms for the delivery of administrative and common services. This includes privatizing all or part of the printing, publishing and information services of the Canada Communications Group.

Annex Table 27
Public Works and Government Services

	1994-95	1995-96	1996-97
		(millions of dollars)	
Services Program	5	1	
Real Property Program	1,142	1,245	
Supply and Services Program	654	529	
Other (Crown corporations)	13	8	
Total	1,814	1,783	1,594

Statistics Canada

Statistics Canada's core responsibilities include the collection and analysis of statistical information on Canada's economic, financial and social structure. As a result of 1995 budget actions, Statistics Canada cut the frequency of certain programs and streamlined its operations. Funding for Statistics Canada is expected to be flat during the next two years except for a temporary top-up for the 1996 Census.

Annex Table 28
Statistics Canada

	1994-95	1995-96	1996-97
		(millions of dollars)	
General Statistical Information	244	236	
Census Related	31	52	
Total	275	288	406

Major Transfers to Persons

The federal government spent $36.7 billion in 1994-95 on direct income support for individuals. Expenditures in this category are comprised of payments to the elderly, the unemployed and veterans. These payments account for about 31 per cent of total program spending – the single largest category of spending. The largest and increasing share of payments go to the elderly and the unemployed.

Elderly Benefits

Direct federal spending on elderly benefits, which includes the Old Age Security (OAS), the Guaranteed Income Supplement (GIS) and Spouses' Allowance (SPA) programs is projected to be $21.3 billion in 1995-96:

■ Old Age Security (OAS) is paid monthly (maximum benefit of $394.76 – October 1995) to Canadians aged 65 and over. OAS payments are taxable and recovered from high-income seniors upon tax filing. Payments are currently recovered at a rate of 15 per cent of individual income over $53,215, which means that the benefit is fully recovered at an income of about $84,500. This recovery will yield about $400 million in 1995-96. The 1995 budget introduced further measures to recover OAS payments from high-income persons. Effective July 1996, OAS benefits will be paid out net of high-income recovery amounts, while OAS recipients no longer residing in Canada will have to submit a statement of their world-wide income in order to continue to receive OAS benefits.

■ Guaranteed Income Supplement (GIS) is a non-taxable monthly benefit (maximum single benefit of $469.13 per month – October 1995) paid to lower-income OAS recipients on the basis of family income. The maximum income, including OAS, below which GIS is payable is about $16,000 for a single pensioner and about $24,200 for married pensioners. More than 40 per cent of OAS/GIS benefits go to the low-income seniors who qualify for GIS.

■ Spouses' Allowance (SPA) is a non-taxable benefit (maximum widowed benefit of $773.16 per month – October 1995) paid to low-income individuals aged 60 to 64 who are spouses of OAS pensioners or are widow(er)s. Like GIS, this benefit is based on net family income.

Payments to the elderly are one of the fastest growing areas of program spending. Elderly benefits now account for just less than 20 per cent of program spending, up from 14.5 per cent just a decade ago. This growth reflects increases in the elderly population and the fact that benefits are fully indexed to inflation. Elderly payments will continue to grow at a steady rate through 2010. After 2010 elderly payments will rise sharply as the "baby boom" generation starts to retire. The proportion of elderly people in the population will almost double in the next 40 years.

Annex Table 29
Elderly Benefits

	1994-95	1995-96	1996-97
	(billions of dollars)		
Expenditures			
Old Age Security	15.5	16.2	16.7
Guaranteed Income Supplement	4.6	4.7	4.8
Spouse's Allowances	0.4	0.4	0.4
Total	20.5	21.3	21.9
Tax Measures			
Age Credit	1.5	1.4	1.3
Pension Income Credit	0.3	0.3	0.4
Taxation of OAS benefit	-1.9	-2.0	-2.1
OAS repayment	-0.4	-0.4	-0.5
Total	-0.5	-0.7	-0.9
Total assistance	20.0	20.6	21.0

In addition to the three spending programs, elderly Canadians are also eligible for two tax credits, which lower income tax payable.

■ Individual taxpayers aged 65 or over are entitled to claim a maximum federal tax credit of 17 per cent of $3,482. Beginning with the 1994 taxation year, the age credit is income-tested. The credit is reduced based on the amount by which an individual's net income exceeds $25,921.

■ Individual taxpayers are entitled to claim a federal tax credit of 17 per cent on the first $1,000 of private pension income. About three-quarters of those claiming the credit are age 65 or over and one-quarter are under 65.

The following table shows the distribution, by household income, of net elderly benefits, on an after-tax basis. Nearly three-quarters of the benefits go to households with incomes less than $30,000.

Annex Table 30
Distribution of Net Federal Elderly Benefits[1] by Household Income 1995

Household income[2]	Number of households[3]	Net benefit
(dollars)	(thousands)	(millions of dollars)
Less than 15,000	810	7,050
15,000 to 20,000	390	2,840
20,000 to 25,000	370	3,110
25,000 to 30,000	240	1,670
30,000 to 40,000	350	2,320
40,000 to 50,000	190	1,230
50,000 to 60,000	130	770
60,000 to 75,000	90	500
Over 75,000	130	630
Total	2,700	20,120

1 OAS (net of taxes), GIS, SPA, pension income and age credit. (Does not include pension income credit and SPA received by non-elderly families.)

2 Total income of head and spouse including OAS, GIS, and SPA received by them.

3 Households with at least one person age 65 or older.

The Canada Pension Plan (CPP) is a contributory, earnings-related social insurance program which ensures a measure of income protection to a contributor and his and her family against the loss of income due to retirement, disability, or death. The plan operates throughout Canada except in the province of Quebec, where a similar program – the Quebec Pension Plan (QPP) is in effect.

Canada Pension Plan premiums and benefits are not part of the federal government's revenues or expenditures and therefore do not affect the federal government's deficit.

Unemployment Insurance Benefits

Benefits under the Unemployment Insurance Program are paid from the Unemployment Insurance Account. In 1994, payments for unemployment insurance and developmental uses amounted to $15.4 billion. On average, about 1.1 million Canadians received unemployment insurance benefits each month in 1994. Administrative and other expenses amounted to $1.7 billion, bringing total program costs to $17.1 billion.

Since 1990, all expenses incurred by the account are to be financed through employee and employer contributions. Employers pay 1.4 times the employee premium rate. Unemployment insurance premium

contributions by employers and employees totaled $19.3 billion in 1994. Another $82 million was received from penalties.

As a result, there was an *annual* surplus of $2.3 billion in 1994. This helped to reduce the *accumulated deficit* in the account to $3.6 billion by the end of 1994.

Premium contributions to the account form part of the federal government's overall budgetary revenues. Likewise, costs of the program are part of overall program spending. Annual deficits or surpluses in the account therefore directly affect the federal government's financial situation.

Unemployment insurance benefits are taxable as income and unemployment insurance premiums give rise to a tax credit. Claimants whose annual net income (including unemployment insurance benefits) is more than a prescribed limit ($61,230 in 1994) must repay 30 per cent of benefits in excess of the prescribed limit. Benefit repayments from higher-income claimants were estimated at $48 million in 1994. These repayments are credited to the account and help finance program expenses.

Annex Table 31
The Unemployment Insurance Account – 1994

	(billions of dollars)
Revenues	
Premiums	19.3
Penalties	0.1
Total	19.4
Expenses	
Benefits	
Regular	11.8
Maternity/parental	1.2
Sickness	0.4
Fishing	0.2
Total	13.6
Developmental Uses Program	1.8
Total benefits	15.4
Administration costs	1.3
Other (interest, doubtful debts)	0.4
Total expenses	17.1
Surplus for the year	2.3
Cumulative deficit at year end	-3.6

Important structural changes were recently announced by the Minister of Human Resources Development. The proposed reform strengthens incentives to get Canadians back to work. Benefits will be more closely tied to previous work, as they will be assessed in terms of "hours worked" rather than "weeks worked", while total earnings will be covered up to an annual maximum. Seasonal workers will be encouraged to work in the off-season by averaging insurable earnings. Frequent users of unemployment insurance will face a reduction in their benefit rate. Coverage will be focused on those with lower earnings, by reducing maximum insurable earnings and reducing the threshold at which benefits are clawed back from high-income persons.

Annex Table 32
Unemployment Insurance Benefits

	1994-95	1995-96	1996-97
		(billions of dollars)	
Regular benefits	11.3	9.8	10.0
Special uses benefits	1.9	1.9	2.0
Development uses	1.8	1.9	2.1
Total[1]	15.0	13.6	14.1

[1] Components may not add to total due to rounding.

Unemployment insurance reform will also re-invest in people by promoting self-sufficiency and employment. Under a fully mature system, about $800 million will be redeployed within Human Resources Development Canada to set up adaptable employment programs to get unemployed Canadians back to work.

Major Transfers to Other Levels of Government

The provinces, territories and municipalities receive transfers from the federal government to support Canada's health care system, post-secondary education, social assistance and provision of general public services.

In 1995-96, provincial, territorial and municipal governments will receive about $39 billion in financial transfers – both cash and tax point transfers. Of this amount, $26.4 billion will be cash, while more than $12.6 billion will take the form of tax transfers. A tax transfer consists of

co-ordinated action by the federal government to reduce its taxes, allowing provinces to increase their taxes. In this way, revenues that would have otherwise gone to the federal government flow to the provinces.

Annex Table 33
Major Transfers to Other Levels of Government

	1994-95	1995-96	1996-97
		(millions of dollars)	
EPF/CAP – CHST			
Total entitlements	29,930	29,839	26,900
Cash transfer[1]	17,443	16,707	12,993
Tax point transfer	12,487	13,132	13,907
Equalization	8,543	8,512	8,895
Transfers to territories	1,196	1,155	1,116
Total			
Total entitlements[2]	38,869	38,702	36,096
Cash	27,182	26,374	23,004

[1] Figures include prior year adjustments.

[2] Equalization associated with EPF/CHST tax points appears in both Equalization and EPF/CHST entitlements. It has been subtracted from "Total entitlements" to avoid double counting.

EPF/CAP – CHST

A fundamental change was made to provincial and territorial transfers with the introduction of the Canada Health and Social Transfer (CHST) in the 1995 budget. The new block transfer will replace Established Programs Financing (EPF) and the Canada Assistance Plan (CAP) starting in 1996-97.

The CHST will provide funding for Canada's major health and social programs.

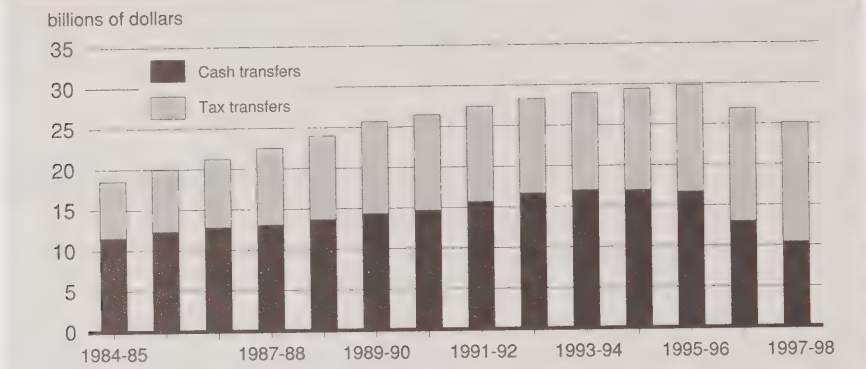
Unlike the old programs, such as CAP, the CHST will provide more scope for provinces to innovate and reform their programs, thus allocating resources where they are most needed, ending the intrusiveness of current cost-sharing arrangements.

The CHST will not be totally unconditional, however. The federal government will continue to enforce the Canada Health Act.

EPF/CAP – CHST entitlements are set to decline from $29.9 billion in 1994-95 to $25.1 billion in 1997-98, with cash transfers declining somewhat faster. The government has pledged to maintain a sustainable level of cash payments under the CHST.

The total CHST entitlement for 1996-97 is set at $26.9 billion. To provide provinces with certainty, CHST transfers will be allocated among provinces that year in the same proportion as provincial entitlements under combined CAP and EPF transfers in 1995-96. The Minister of Finance will be consulting with provinces shortly on how the allocation of the CHST could be made for years after 1996-97.

Annex Chart 1.1 EPF/CAP - CHST



Equalization

Equalization is unique in that its purpose is enshrined in the Constitution. Following discussions with the provinces, Equalization has been renewed for a five-year period beginning in 1994-95, providing stable financing for this program to the end of the century.

Equalization provides unconditional financial assistance to provinces that have below-standard revenue-raising capacities. It enables the less well-off provinces to provide Canadians with comparable levels of public services at comparable levels of taxation.

Equalization entitlements are calculated on the basis of a formula set out in federal legislation. Under this formula, each province's revenue-raising capacity is compared to the average fiscal capacity of a five-province standard. On a per-capita basis, any province whose revenue is below the five-province standard receives Equalization. The program is subject to a ceiling which limits the growth in Equalization entitlements to the growth

in the Gross National Product (GNP) from a 1992-93 base. It also has floor provisions which protect each receiving province against a sharp annual decline in its Equalization.

Annex Table 34
Equalization Entitlements

	1994-95	1995-96	1996-97
		(millions of dollars)	
Newfoundland	958	926	977
Prince Edward Island	201	202	211
Nova Scotia	1,146	1,095	1,141
New Brunswick	887	945	983
Quebec	3,716	3,806	3,994
Manitoba	1,080	1,074	1,113
Saskatchewan	554	464	476
Total[1]	8,543	8,512	8,895

[1] Totals not exactly equal to sum of components due to rounding.

Territorial Formula Financing

The governments of the Northwest Territories and Yukon receive Formula Financing assistance to enable them to provide a range of public services comparable to those offered by the provinces. Transfers to the territories are calculated as the difference between territorial governments' expenditure requirements and their revenue means.

The 1995 budget announced that for 1995-96, entitlements for each territory are frozen at 1994-95 levels. In the subsequent fiscal year, the Gross Expenditure Base used in the formula will be cut by 5 per cent for each territory.

On October 4, 1995, the federal government and the governments of the territories announced a renewal of the Territorial Formula Financing Agreements for four years effective from April 1, 1995. The new agreements will expire on April 1, 1999 to coincide with the creation of Nunavut.

Annex Table 35
Transfers to Territories

	1994-95	1995-96	1996-97
		(millions of dollars)	
Current funding	1,196	1,155	1,116

Other Transfers

Apart from the major transfer programs, other smaller transfers also play an important role in providing financing to the provinces and territories.

■ Grants in lieu of taxes are paid by the federal government to municipalities in respect of municipal services provided to federal facilities. The 1994 budget froze payments under this program in 1993-94 and 1994-95 at 1992-93 levels as part of overall fiscal restraint.

■ To compensate for revenues lost on joining Confederation, the federal government provides statutory subsidies to the provinces.

■ Fiscal Stabilization provides financial assistance to any provincial government faced with a year-over-year decline in its revenues due to other than tax rate changes (i.e. due to a severe economic downturn). Payments to provinces totalling $1.1 billion were made to compensate them for revenue declines during the recent recession. Starting in 1995-96, compensation will only be provided for year-over-year revenue declines exceeding 5 per cent.

■ Youth Allowances Recovery: The federal government in the 1960s offered to the provinces an alternative method of financing for certain federal-provincial programs. The financing arrangement permitted any province to assume the administration of these programs by receiving "tax room" from the federal government. The Quebec government was the only province to choose this arrangement. One of the programs financed by this new arrangement was Youth Allowances. The federal government reduced personal income taxes in Quebec by three points to finance this program. Subsequently, the program was discontinued and now a payment is made each year by Quebec to the federal government to recover the value of the tax points.

Annex Table 36
Other Transfers

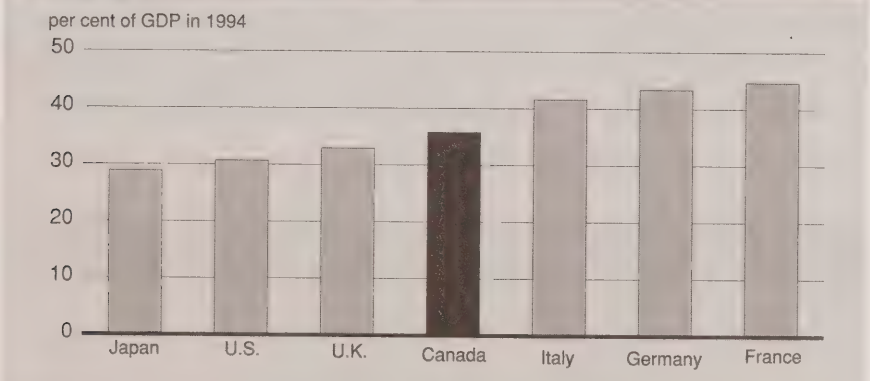
	1994-95	1995-96	1996-97
	(millions of dollars)		
Municipal grants	408	426	426
Statutory subsidies	38	38	38
Stabilization	0	0	0
Youth Allowances Recovery	-393	-422	-449
Total	53	42	15

Annex 2

Overview of Government Revenues

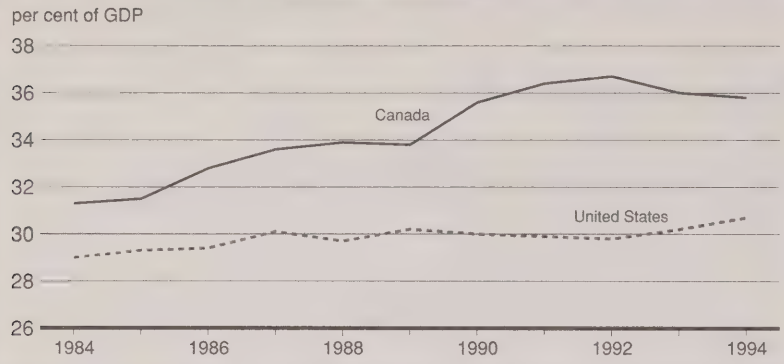
This section provides background on government tax revenues in Canada. In 1994, total tax revenues on a national account basis stood at $268.6 billion, which represented about 35.8 per cent of GDP. This placed Canada above the U.S. (for which tax revenues represented 30.7 per cent of GDP) and in the middle of the G-7 countries.

Annex Chart 2.1 Comparison of total tax revenues – G-7



In Canada, tax revenues have grown significantly relative to GDP. Between 1980 and 1994, tax revenues as a percentage of GDP increased from 29.5 per cent to 35.8 per cent (a 21.5 per cent increase). In comparison, tax revenues in the U.S. as a percentage of GDP increased from 29.8 per cent to 30.7 per cent (a 3.3 per cent increase) over the same period.

Annex Chart 2.2 Comparison of government tax revenues – Canada-United States



Federal Revenues

On a public accounts basis, as reported in the *Annual Financial Report* for 1994-95, federal government revenues amounted to $123.3 billion in 1994-95. Personal income tax is the most important revenue source for the federal government, at 46 per cent of total revenues. Sales and excise taxes, which include the Goods and Services Tax, customs import duties, motive fuel excise taxes and other excise taxes and duties, are the second largest federal revenue source, at 22 per cent of the total, followed by unemployment insurance premiums (15 per cent), and corporate income tax (9 per cent). Other revenues (8 per cent) include items such as return on investment (Bank of Canada profits, interest income, etc.) and other miscellaneous tax and non-tax revenues.

Annex Chart 2.3 Federal revenue mix: 1994-95

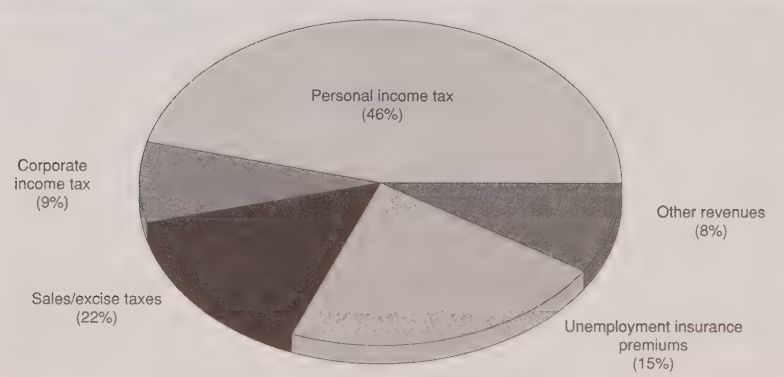


Table 37 provides an overview of the outlook for the major revenue components to 1996-97. Budgetary revenues are expected to increase to $131.2 billion in 1995-96, up 6.4 per cent from 1994-95. In 1995-96, revenues are expected to grow slightly faster than the economy, primarily due to the progressivity of the personal income tax system, with higher marginal tax rates at higher levels of taxable income, and the partial indexation of its parameters, as well as increased profitability of the corporate sector. In addition, measures introduced in recent budgets to tighten tax preferences and to increase certain excise tax rates contribute to the growth in revenues. In 1996-97, revenue growth slows to 3.8 per cent mainly due to lower unemployment insurance contributions and non-tax revenues.

Annex Table 37
Budgetary revenues

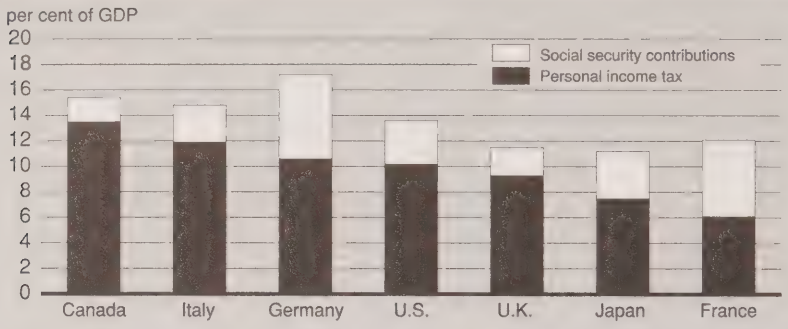
	1994-95	1995-96	1996-97
		(millions of dollars)	
Personal income tax	56,329	59,900	63,500
Corporate income tax	11,604	14,350	15,700
Unemployment insurance premiums	18,928	19,520	19,450
Goods and Services Tax	16,786	17,300	18,150
Excise taxes and duties	10,303	10,485	10,515
Other tax revenues	1,769	1,865	1,780
Non-tax revenues	7,604	7,740	6,990
Total revenue	123,323	131,160	136,085

Tax on Personal Income

In 1993, tax on personal income in Canada stood at 15.4 per cent of GDP on a national accounts basis, and was higher than in all other G-7 countries except Germany, which was at 17.2 per cent. It includes both personal income taxes and the employee portion of social security contributions (in Canada, these are primarily unemployment insurance premiums and Canada/Quebec Pension Plan contributions).

Relative to other G-7 countries, Canada relies to a much greater extent on personal income taxes, which were 13.5 per cent of GDP. Social security taxes represented 1.9 per cent of GDP, the lowest share among the G-7 countries.

Annex Chart 2.4 Taxes on personal income in G-7 countries: 1993



Tax Burden on Corporations

Canadian corporations pay a variety of taxes and other levies to the various levels of government in Canada:

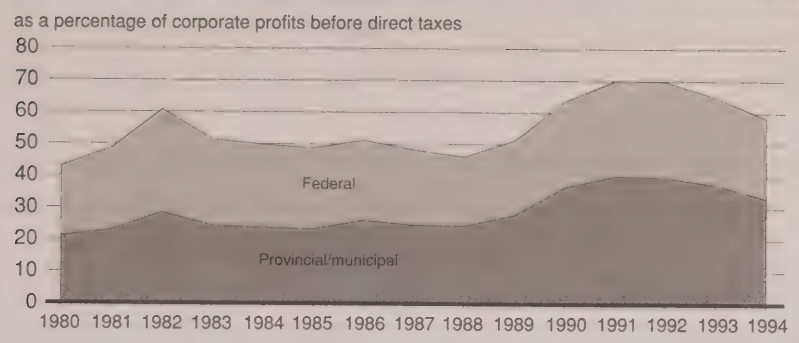
- corporate income taxes;
- capital and insurance premium taxes;
- payroll levies (e.g., health taxes, Unemployment Insurance, Canada Pension Plan, Quebec Pension Plan, Workers' Compensation);
- property taxes; and
- indirect taxes, such as sales and excise taxes, on business inputs.

With the exception of corporate income taxes, these taxes incurred by corporations do not vary with the level of profits and must be paid whether or not the corporation makes a profit. Direct taxes that are not based on profits represent approximately 70 per cent of all direct taxes paid by corporations.

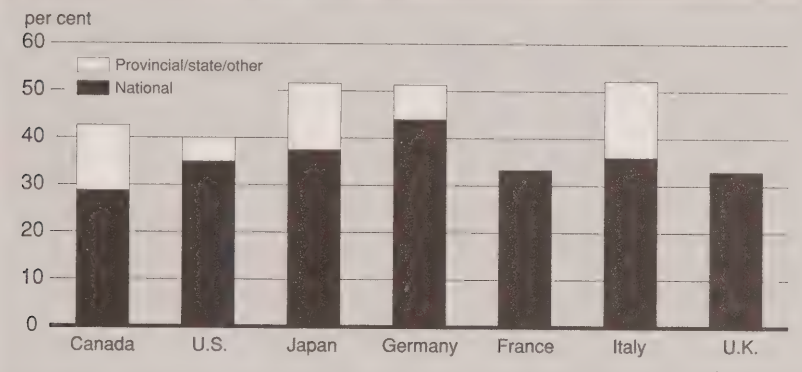
In 1994, Canadian corporations paid about $55 billion in direct taxes: about $24 billion to the federal government and $31 billion to provincial and municipal governments.[1] This amount is an increase from $36 billion (1994 dollars) in 1980. Measured as a percentage of pre-tax corporate

[1] Exact figures on the amount of indirect taxes paid by the corporate sector are unavailable. However, estimates suggest that these taxes represent a relatively small component of the total corporate tax burden.

Annex Chart 2.5 Total corporate direct taxes



Annex Chart 2.6 International comparison of corporate income tax rates: 1994



profits, direct taxes also increased significantly between 1980 and 1994 from 43.0 per cent to 58.4 per cent.

Income tax rates can be an important consideration in investment and location decisions by business, especially in the context of today's integrated global economy. Canadian rates are near the middle of the range in the G-7 countries.

Major Tax Expenditures

In raising revenues the tax system provides assistance or incentives to particular groups of individuals, businesses, or to certain activities. Tables 38 and 39 sets out some of these tax expenditures where the federal revenue

foregone in each case likely exceeds $300 million. Short descriptions of the measures follow the table. It should be noted that the estimated cost of each tax expenditure takes no account of possible changes which could affect revenues, such as changes in taxpayer behaviour. Consequently, eliminating the measure would not necessarily increase revenues by the amount shown. Descriptions of all tax expenditures and the revenue foregone may be found in *Tax Expenditures*, published annually by the Department of Finance.

Annex Table 38
Major income tax expenditures[1]

	1992
	(millions of dollars)
Non-taxation of lottery and gambling winnings	
Education and tuition fee credits	365
Married/equivalent to married credit	1,725
Child tax benefit[2]	5,273
Partial inclusion of capital gains	745
Non-taxation of employer-paid health and dental benefits	1,125
Non-taxation of social assistance benefits	680
Non-taxation of workers' compensation benefits	610
Age and pension income credits	1,650
Tax assistance for retirement savings	13,600
$500,000 lifetime capital gains exemption on small business shares	785
Charitable donations credit	865
Low tax rate for small businesses	1,934
Low tax rate for manufacturing and processing	368
R&D investment tax credit	597

1 The elimination of a tax expenditure would not necessarily yield the full revenues shown in the above table. The actual increase in revenues would depend on the design of the tax change and resulting changes in behaviour. For instance, the theoretical yield from full taxation of lottery and gambling winnings is estimated to be $900 million. However, the actual potential revenues from such a tax would be much less if prizes under a certain value were excluded.

2 Estimate is for 1993, the first year of the program.

Lottery and gambling winnings

Lottery and gambling winnings are not subject to tax. The federal government has agreed to vacate the lottery field in return for payments by the provinces ($49.5 million was received in 1994-95). The forgone tax revenues from this tax expenditure were estimated at $900 million for 1992. This estimate reflects only lottery and horseracing gains; it does not include other types of gambling for which accurate data are unavailable. However

the actual potential revenue from the taxation of these winnings would depend on design issues such as, whether there would be a threshold under which prizes would not be taxable.

Education and tuition fee credits

Tax assistance is provided to students enrolled at prescribed educational institutions such as universities and colleges. A 17-per-cent tax credit is available for tuition fees above $100 paid by students to prescribed educational institutions. In addition, students can claim an education tax credit of 17 per cent of $80 for every month of full-time attendance. Amounts not used by the student may be transferred to a supporting spouse, parent or grandparent, to a maximum of $4,000. The tax assistance provided to students through these federal tax credits amounted to $365 million in 1992.

Married and equivalent-to-married credits

A married taxpayer supporting a spouse is entitled to a tax credit of 17 per cent of $5,380 for taxation year 1995. This is reduced by 17 per cent of the amount by which the dependent spouse's income exceeds $538. Similarly, single parents can claim an equivalent-to-married tax credit in respect of a child. The amount of the credit and the limitation of the dependent child's income are the same as those for the married credit. These credits recognize that taxpayers in one-earner or single-parent families have a reduced ability to pay tax relative to taxpayers with the same income but without a financially dependent spouse or child to support. This tax expenditure cost the federal government $1.725 billion in 1992.

Child tax benefit

The child tax benefit was introduced in 1993, replacing the family allowance, the dependent credit for children under 18 years of age and the refundable child tax credit.

The child tax benefit is paid monthly and is non-taxable. The basic benefit is $1,020 per child annually, plus $75 for the third and each subsequent child. It also includes a supplement of up to $213 for each child under age 7. The combined total benefit is reduced by 5 per cent (2.5 per cent for one-child families) of family income over $25,921.

The child tax benefit also includes an earned income supplement for low-income working families. The supplement is equal to 8 per cent of the family earned income in excess of $3,750 (to a maximum supplement of $500). The supplement is reduced by 10 per cent of family net income in excess of $20,921.

In 1994, $5.3 billion was paid out in child tax benefits.

Partial inclusion of capital gains

Only three-quarters of net realized capital gains accrued since 1972 are included in income. The remaining one-quarter of the capital gain is tax free. This reduced income inclusion rate provides an incentive for individuals and corporations to invest by increasing the after-tax return on their investment and provides some recognition of the inflation-related portion of capital gains. This measure involved an estimated federal tax expenditure for 1992 of $745 million.

Non-taxation of employer-paid health and dental benefits

Approximately 8 million employees receive employer-paid health and dental benefits tax-free while other individuals without plans have to finance such expenses out of after-tax income. The non-taxation of these benefits is estimated to have cost the federal government $1.125 billion in forgone revenues in 1992.

Non-taxation of social assistance benefits

Social assistance benefits received by low-income Canadians are not taxable. These payments must be included in income but an offsetting deduction from net income is provided. The benefit levels are determined on the basis that benefits are non-taxable. The non-taxation of social assistance payments cost the federal government $680 million in forgone revenues in 1992.

Non-taxation of workers' compensation benefits

Workers' compensation benefits are not taxable even though contributions to Workers' Compensation Boards are deductible. Normally, where a deduction or credit has been allowed for premiums, benefits are taxable. Workers' Compensation Boards, established under provincial authority, set

benefits levels on the assumption that benefits are not taxable. Generally, the benefit rate is 90 per cent of after-tax earnings, to a dollar maximum. The non-taxation of workers' compensation cost the federal government $610 million in forgone tax revenues in 1992.

Age and pension income credits

Individual taxpayers aged 65 or over are entitled to claim a maximum federal tax credit of 17 per cent of $3,482. Beginning with the 1994 taxation year, the age credit has been income-tested. The credit is reduced based on the amount by which an individual's net income exceeds $25,921. Individual taxpayers are also entitled to claim a federal tax credit of 17 per cent on the first $1,000 of private pension income. About three-quarters of those claiming the credit are age 65 or over and one-quarter are under 65. The age credit cost the federal government $1.355 billion in 1992. Income-testing the credit, which was announced in the 1994 budget, is estimated to reduce its 1995 cost by about $300 million. The pension income credit cost $295 million in 1992. Together these two credits for older Canadians cost the federal government $1.65 billion in 1992.

Tax assistance to retirement savings

The level of tax assistance provided to saving in registered pension plans, deferred profit sharing plans and registered retirement savings plans was estimated to be $13.6 billion at the federal level in 1992. This tax assistance results from the deferral of tax on income contributed to these plans, and on investment income earned inside the plans, until benefits are paid out. Each year, about nine to ten million individuals either claim deductions for contributions to retirement savings plans or receive benefits from them. Private saving for retirement plays a major role in the retirement income security of Canadians, and this role is increasing in importance as the "baby boom" generation moves towards retirement age.

$500,000 lifetime capital gains exemption for small business shares

A $500,000 lifetime capital gains exemption is available in respect of the disposition of small business shares. The exemption was designed to encourage investment in small business, provide retirement support and facilitate transfers. This tax expenditure cost the federal government $785 million in 1992.

Charitable donations credit

A tax credit of up to 20 per cent of net income is available in respect of donations by individuals to registered charities. Donations in excess of 20 per cent may be carried forward up to five years. The credit is 17 per cent on the first $200 of donations ($250 prior to taxation year 1994) and 29 per cent on the remaining portion. The purpose of the credit is to provide an incentive for charitable giving in recognition of the important work of charities. The estimated cost of this measure was $865 million for taxation year 1992.

Small business deduction

The small business deduction reduces the basic federal corporate tax rate on the first $200,000 of income earned by Canadian-controlled private corporations from 28 per cent to 12 per cent. This lower tax rate provides small corporations with more after-tax income for reinvestment and expansion to recognize the special financing difficulties they face. This measure had an estimated tax expenditure for 1992 of $1.934 billion and, in conjunction with other special tax measures for small business, provides Canadian small businesses with a more favorable income tax regime than in most other countries.

Manufacturing and processing profits deduction

The manufacturing and processing (M&P) profits deduction reduces the basic federal corporate tax rate on M&P income from the general rate of 28 per cent to a rate of 21 per cent. This lower tax rate provides M&P corporations with more after-tax income for reinvestment which increases their productivity and enhances their ability to compete in international markets. This measure had an estimated tax expenditure for 1992 of $368 million.

R&D investment tax credits

R&D investment tax credits are provided in recognition of the fact that the benefits of R&D accrue beyond the R&D performer to other participants in the economy. These credits are intended to encourage firms to perform R&D in Canada and are important given the key role of R&D in the emerging new economy. The current system of tax credits for R&D

provides significant tax relief (the estimated tax expenditure for 1992 is $597 million). Indeed, studies have shown that the Canadian system of R&D tax incentives is one of the most attractive in the world particularly when one includes the incentives offered by some provinces.

Other income tax expenditures

While the above list describes the major income tax expenditures, the publication *Tax Expenditures* provides a comprehensive listing of all tax expenditures. These range from those where the revenue forgone is relatively close to the $300 million cutoff, such as the deduction of limited partnership losses to lower cost ones such as the logging tax credit and the deduction for employee stock options.

Annex Table 39
Goods and Services Tax expenditures

	1992
	(millions of dollars)
Zero-rated goods and services	
Basic groceries	2,455
Tax exempt goods and services	
Long-term residential rent	1,015
Health care services	325
Education services (tuition)	305
Tax rebates	
Rebates for municipalities	500
Housing rebate	440
Tax credits	
GST credit	2,490

Zero-rated goods and services

Basic groceries

Basic groceries, which include the majority of foodstuffs for preparation and consumption at home, are zero-rated under the GST. However, the tax is charged on certain goods such as soft drinks, candies and confections, and alcoholic beverages.

Tax-exempt goods and services

Long-term residential rent

Rentals of a residential complex (such as a house) or a residential unit (such as an apartment) for a period of at least a month are tax exempt. Short-term accommodation is also exempt where the charge for the accommodation is not more than $20 per day.

Health care services

Health care services are exempt under the GST. These services include the following categories:

- institutional health care services provided in a health care facility. These include accommodation, meals provided with accommodation, and rentals of medical equipment to patients or residents of the facility. However, it excludes meals served in a cafeteria, parking charges, or haircuts for which a separate fee is charged.

- services provided by certain health care practitioners who must be licensed or otherwise certified to practise the particular profession in provinces. This category includes services such as dental, optometric, chiropractic, physiotherapy, chiropodic, podiatric, osteopathic, audiological, and psychological services. It also includes speech therapy and occupational therapy.

- services covered by a provincial health insurance plan. Most of these services are already covered by the previous two provisions.

All those exempt services which are covered by provincial health insurance plans are not considered as a tax expenditure because, constitutionally, the GST cannot apply to purchases made by provincial governments.

Education services (Tuition)

The GST provides an exemption for most educational services. The exemption includes tuition fees paid for courses provided primarily for elementary or secondary school students; courses leading to credits towards a diploma or degree awarded by a recognized school authority, university or college; and certain other types of training for a trade or vocation. In addition, the exemption covers meals supplied to elementary or secondary students as well as most meal plans at a university or public college.

The estimate is derived from the revenues that would be collected if tuition fees were taxed and input tax credits were allowed for taxable purchases. The estimate takes into account the fact that universities and public colleges currently receive a rebate of 67 per cent of the tax that they pay on their purchases.

Tax rebates

Rebates for municipalities

Recognized municipalities are entitled to a rebate of 57.14 per cent of the GST paid on their purchases used in the course of supplying exempt municipal services.

Housing rebate

Purchasers of newly constructed residential dwellings and substantially renovated houses are eligible for a rebate of the GST paid if the purchaser is acquiring the dwelling as a primary place of residence. For houses priced at or below $350,000, the rebate is 36 per cent of the total GST paid. The rebate is phased out for houses priced between $350,000 and $450,000.

Tax credits

The GST credit

As part of the introduction of the GST, a GST credit was established to provide sales tax relief to low- and modest-income families. The amount of the GST credit depends upon family size and income. The basic adult credit is $199 a year in 1995. Families with children 18 years and younger receive a basic child credit of $105 for each child. However, single parents can claim a full adult credit of $190 for one dependent child. In addition to their basic credit, single adults (including single parents) are eligible for an additional credit of up to $105. The value of the credit is reduced for families with income of over $25,921. Both the credit amounts and the income threshold are adjusted annually to increases in the consumer price index in excess of 3 per cent.

Revenue Impacts of Changes in Selected Tax Parameters

The sensitivity of revenue to illustrative changes in selected tax parameters is set out in the following table.

Annex Table 40
Estimated revenue impact of tax parameter changes (when mature)

	(millions of dollars)
Personal income tax	
Federal surtax (per percentage point)	
On total basic federal tax	660
On basic federal tax above $12,500	100
Change in marginal rates (per percentage point)	
Lowest rate (17 per cent)	1,950
Middle rate (26 per cent)	880
High rate (29 per cent)	420
All	3,250
$10 change in selected credits	
Basic personal credit	150
Married/equivalent to married credit	25
Age credit	25
Corporate income tax	
Rate changes (one percentage point)	
General income tax rate	315
Manufacturing and processing tax rate	110
Small business income tax rate	170
Surtax	120
Large corporation tax	
0.025 per cent change	160
Sales and excise taxes and duties	
GST (one percentage point change)	2,985
One cent per litre motive fuel	555
1 per cent in excise levies	
Spirits	5
Beer	6
Wine	1
Tobacco	20

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The Economic and Fiscal Update

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Canada

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1

Introduction and Overview

The ultimate objectives of the government's economic policy are to foster growth and the creation of well-paying jobs, within a fair and caring society. To achieve this, the government has focused on three basic building blocks:

- getting the economic foundation right – a key element of which is restoring health to the nation's finances;
- reforming social programs to ensure their sustainability; and
- providing Canadians and Canadian business with the support they require to take full advantage of the opportunities in the modern economy.

Reducing the deficit and the debt-to-GDP ratio (the size of the government's debt in relation to the economy ... this is a measure of the country's ability to pay) has been only one part of an overall jobs and growth strategy. But it has been an essential part. Three years ago, the federal government's finances were out of control. Expenditures had exceeded revenues for more than 20 years. Interest costs were eating up one-third of each revenue dollar. Debt in relation to GDP had surpassed 70 per cent and was continuing to rise unabated.

This untenable situation required determined and immediate action.

The last three budgets have put in place the measures necessary to achieve lasting deficit reduction and to reverse the rise in the debt-to-GDP ratio. This fiscal strategy has been based on reducing government spending rather than increasing taxes, improving the way government operates and refocusing spending and revenues to priority areas.

Taking stock

The strategy is on track ...

This Update is being published concurrently with the *Annual Financial Report of the Government of Canada – Fiscal year 1995-96*. The Report shows that the federal deficit for 1995-96 came in at $28.6 billion. This means that the government has bettered its deficit target for a second year in a row and is on track to hit its deficit target of $24.3 billion for 1996-97 and $17 billion for 1997-98.

The provinces have also achieved significant fiscal improvement. As a result, Canada's total government deficit will decline from among the highest in the G-7 in the early 1990s to the lowest by 1997.

The transition to a healthier fiscal situation has entailed difficult adjustments that have sometimes obscured underlying progress. This is the nature of the early stages of fundamental change.

Structural reform in Canada's large public sector is recent, and no easier than it was for the resource sector in the mid-1980s or the manufacturing or commercial services sectors earlier this decade. The downsizing of the public service sector across Canada has, however, obscured the more vibrant performance of the private sector.

But this reform was necessary and fiscal policy is now working to *complement* monetary policy and other reforms to get the economy on track to meet the challenges of the 21st century.

... and the payoff is starting to emerge

Canada is already experiencing the benefits of its fiscal actions. Investor confidence has strengthened, reflecting the country's excellent inflation performance and fiscal progress. This renewed confidence has resulted in a historic decline in interest rates. Indeed, Canadian interest rates are now well below those in the U.S., on maturities up to five years. The last time short-term interest rates in Canada were lower than in the U.S. was in 1983.

The reduction in the deficit is also contributing to a sharp reversal in the country's reliance on foreign borrowing. In the second quarter of 1996, Canada lent more to non-residents than it borrowed from them. The last time this happened was in 1984.

Buoyed by declining interest rates and an extremely competitive export sector, economic growth is expected to strengthen in the remainder of this year and through 1997. Indeed, the International Monetary Fund (IMF) has recently announced that it expects real GDP growth in Canada to be the strongest in the G-7 next year.

Ensuring continued progress

Although the deficit has been put on a steady downward track, the debt-to-GDP ratio will remain unacceptably high for a number of years to come. The debt ratio will have to be lowered to a more manageable level if Canada is to benefit fully from the difficult decisions that have had to be taken in recent years.

To build on the progress achieved in the last three budgets – and in line with the measured pace of deficit reduction established to date – the deficit target for 1998-99 will be set at $9.0 billion, or about 1 per cent of GDP. Achieving this goal will be a major milestone for Canada. The new deficit target means that Canada's net new borrowing in private credit markets will be eliminated.

The government is committed to continuing reform to make the federal public sector more efficient, effective and flexible. Resources will continue to be reallocated to highest priorities. And the government will continue to strengthen its role in fostering employment growth.

Together these steps will lead to sustained growth and job creation, reduced financial vulnerability and increased policy flexibility.

Outline of *The Economic and Fiscal Update*

This Economic and Fiscal Update reviews, in **Chapter 2**, the costs to Canada of its high debt-to-GDP ratio and the challenges that have had to be overcome in turning it around.

Chapter 3 describes recent economic developments and their implications for the economic assumptions used in budget planning. It stresses that, while the restructuring of the government sector in Canada has been difficult, there are signs that the economy is beginning to respond to the

significantly lower interest rates that have resulted from better fiscal performance at all levels of government. As a result, the economy is expected to strengthen in the latter part of this year and through 1997 as well.

Chapter 4 describes the fiscal implications of the updated economic planning assumptions. The government is on track to meet or better its deficit target for 1996-97. Other fiscal indicators are improving dramatically and the deficit target for 1997-98 will also be achieved. However, even then the debt-to-GDP ratio will still be extremely high, in both an historical and an international context. Correcting these imbalances is necessary to strengthen growth and job creation, and requires the government to keep its finances firmly under control.

Chapter 5 returns to the *Jobs and Growth* agenda – the government's top economic priority. Deficit reduction has always been only one part of a broader strategy to foster sustained strong job creation. While the private sector is the engine of job creation, the government still has a key role to play. The chapter reviews the measures the government has already put in place to support job creation in the private sector.

Chapter 6 presents the conclusions and main issues, including specific questions on which the Finance Committee will be asked to provide advice.

Background material on a number of issues raised in the document is provided in Annexes.

Annex 1 provides analyses of the sensitivity of the deficit to changes in interest rates and GDP.

Annex 2 explains the various measures of the government's fiscal position.

Annex 3 provides an international comparison of Canada's fiscal situation.

2

Creating a Healthy Fiscal Climate: Taking Stock

The fiscal challenge

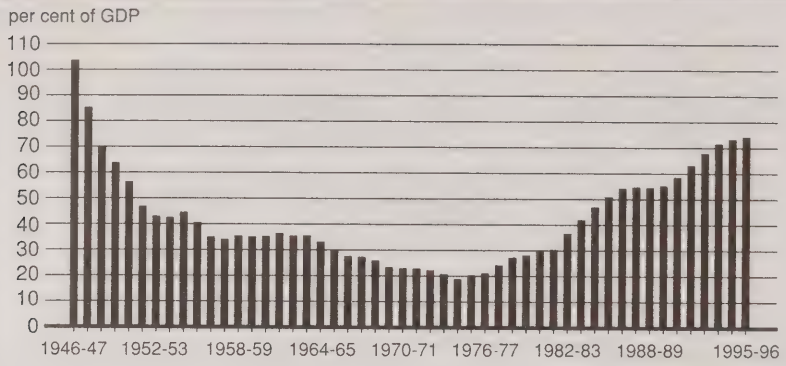
When the government came to office in late 1993, the fiscal situation was clearly not sustainable. The deficit was $42 billion, almost 6 per cent of GDP. The debt-to-GDP ratio was over 70 per cent and growing, having risen virtually without interruption for the previous 20 years (Chart 2.1). The effect of compounding interest on the existing stock of debt meant that, without significant fiscal action, the deficit would have continued to rise from its already crippling level.

Indeed, by 1994-95 Canada's deficit was due solely to debt interest as revenues exceeded program spending (the operating balance was in surplus). The vicious circle of compounding debt is a powerful dynamic to counter. Consider, for example, that if the government had continued to run a policy allowing program spending to equal revenues so that the operating balance were zero (rather than generating substantial operating surpluses under the current policy), then within only five years:

- the stock of debt would have increased by *almost 50 per cent* – to about $800 billion; and
- public debt charges would be approaching $60 billion annually, rather than about $50 billion under current policy.[1]

[1] This assumes that the average effective interest rate on the debt remains at its current level of about 8 per cent.

Chart 2.1 Federal net debt (Public Accounts basis)



The loss of investor confidence associated with such a run-up in the debt would have caused a dramatic increase in interest rates, undermined consumer and investor confidence and increased unemployment. The economic and social consequences of delaying fiscal action would have been profound and eventually, even greater action than has been taken would have been needed to restore fiscal order.

The level and growth in the debt-to-GDP ratio are the crux of the fiscal problem. The debt-to-GDP ratio is the most appropriate measure of the country's ability to service the debt. Just as a household with a higher income can support a larger mortgage, so a country with a higher GDP has the capacity to support a higher public debt.

The challenge posed by the high debt ratio is to generate operating surpluses that are sufficient to fully offset interest charges on the debt and then to maintain these large surpluses until the debt-to-GDP ratio is substantially reduced. This implies maintaining control over program spending and the revenue share of GDP.

The rest of this chapter reviews the consequences of a high debt-to-GDP ratio and then explains the actions that the government has taken to ensure that it is reduced.

The consequences of a high debt-to-GDP ratio

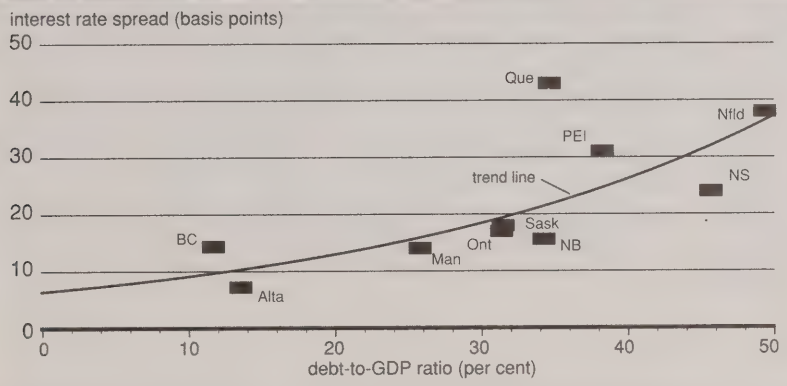
A high debt-to-GDP ratio brings with it a number of adverse economic consequences.

High interest rates

A run-up in the debt-to-GDP ratio can result in high and volatile interest rates. This is because financial markets demand an interest rate risk premium from highly indebted governments.

In Canada, the relationship between the debt-to-GDP ratio and interest rates is most apparent in the different rates of interest paid by provincial governments (Chart 2.2). The higher a province's debt-to-GDP ratio, the higher the interest rate demanded by financial markets. The lower a province's debt-to-GDP ratio, the lower the interest rate it pays. With little variation, this relationship holds across all provinces. A similar relationship can be observed across G-7 countries.

Chart 2.2 Debt-to-GDP ratios and interest rates by province



Interest rate spreads relative to 10-year Government of Canada bond rate as of Sept 26, 1996.
Debt/GDP ratios are 1995-96 Department of Finance estimates.

Because federal government securities are the benchmark for Canadian interest rates in money and capital markets, the rate of interest paid by the federal government sets the standard for all other borrowers. Reducing the high federal debt-to-GDP ratio, therefore, will also reduce interest costs throughout the economy. For example, the lower interest rates achieved between January 1995 and June 1996 have provided

provincial governments with cumulative savings of about $1.3 billion (Table 2.1). As a share of their expenditures, Quebec and Alberta have benefited most to date from this decline in interest rates because a larger portion of their debt is in short-term securities. Others will benefit more as they refinance their existing stock of debt.

Table 2.1
Estimated cumulative savings in debt charges by province
18 months starting January 1995

	Millions of dollars	Per cent of expenditures[1]
Newfoundland	10	0.3
Prince Edward Island	2	0.3
Nova Scotia	15	0.3
New Brunswick	25	0.6
Quebec	625	1.5
Ontario	315	0.6
Manitoba	45	0.8
Saskatchewan	35	0.7
Alberta	165	1.2
British Columbia	75	0.4
Total Provincial	1,312	0.8

[1] Calculated as cumulative interest cost savings divided by total expenditures in 1995.

Source: Department of Finance estimates.

The more general economic benefits that flow from lower interest rates – in terms of higher investment and consumer spending – are well known to many Canadians. To take but one example, the reduction in interest rates since 1995 has resulted in a 15-per-cent increase in housing starts.

High net foreign debt

Persistently high government deficits soak up domestic savings and force a country to borrow abroad.

For example, in 1995 total private savings in Canada were $144.2 billion (Chart 2.3). This was more than sufficient to cover total investment of $123.5 billion. However, because the total government deficit that year was $31.9 billion (on a National Accounts basis), the country had to borrow $11.2 billion abroad. As a result, the stock of debt held by non-residents (the sum of annual net foreign borrowings) increased $11.2 billion. Ongoing deficit financing over the past 20 years has resulted in a run-up in the stock of foreign debt, with the result that Canada now has the highest external debt-to-GDP ratio in the G-7 (Chart 2.4).

Chart 2.3 Sources and uses of savings in Canada (1995)

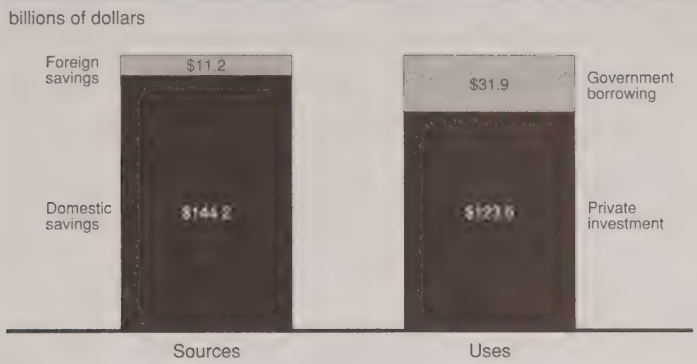
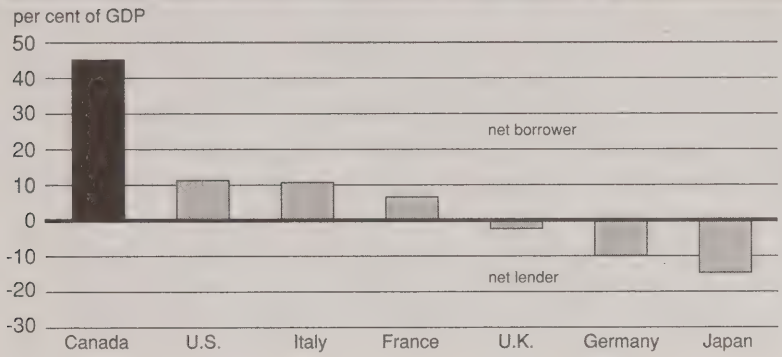


Chart 2.4 G-7 net international indebtedness (1994)



Source: Canada, Department of Finance; rest of the G-7, OECD Economic Outlook, June 1996.

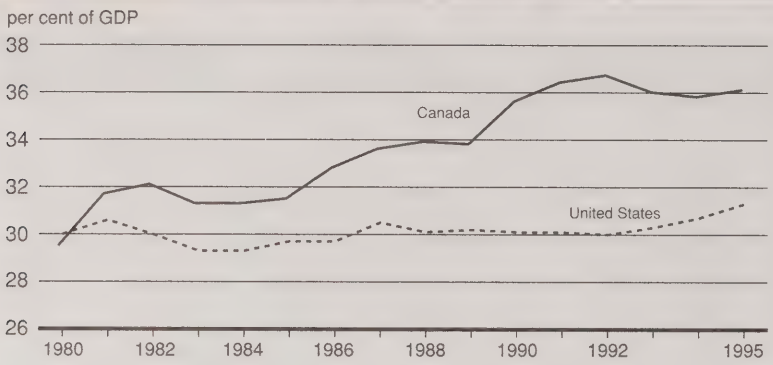
To service the foreign debt, a rising share of income generated in Canada has been flowing abroad. These payments represent a permanent deterioration in the country's standard of living. That creates a situation where non-residents are indirectly exercising a substantial influence over economic decisions made in Canada.

High taxes

A high debt-to-GDP ratio tends to result in heavy tax burdens. This is because highly indebted governments often push up taxes in order to generate the large operating surpluses needed to keep the debt-to-GDP ratio from rising.

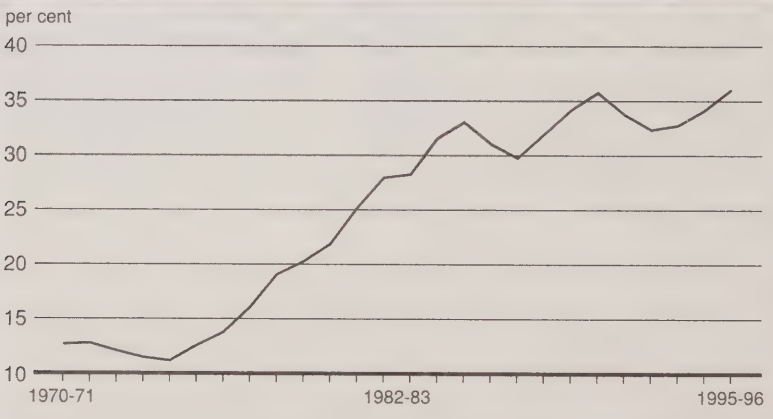
For example, since the early 1980s, the tax burden in Canada increased significantly and much more rapidly than in the United States – our largest trading partner (Chart 2.5). In the past, higher overall taxes in Canada always reflected a higher level of public services. However, particularly over the 1980s, taxes were raised just to help pay for the mounting interest costs on the public debt, rather than to pay for programs and services that could have improved economic performance (Chart 2.6). High taxes are detrimental to employment and output growth and undermine Canada's attractiveness as an investment location.

Chart 2.5 Canada and U.S. total tax revenue



Source: Canada, Department of Finance; U.S.A., OECD Economic Outlook, June 1996.

Chart 2.6 Interest on the debt as a per cent of budgetary revenues



Yet even the increases in taxes over the past decade have not stopped the debt-to-GDP ratio from rising. The debt-to-GDP ratio increased from less than 20 per cent in 1974-75 to over 70 per cent by 1993-94. As a consequence, in 1974-75, about 11 cents of each revenue dollar went to servicing the debt. By 1993-94, this was up to 33 cents. Despite the fiscal actions taken to date, the debt-to-GDP ratio stood at 74.0 per cent at the end of 1995-96 while interest costs amounted to 36 cents of each revenue dollar.

Deficit vulnerable to recessions and high interest rates

A high debt-to-GDP ratio can also leave a country extremely vulnerable to increases in interest rates and economic slowdowns.

In Canada's case, a 100-basis-point increase in interest rates raises the federal deficit by $1.3 billion in the first year and by $3.0 billion after four years. (A more complete discussion of fiscal sensitivities to changes in income growth and interest rates is provided in Annex 1.)

Indeed, high deficits and a high debt-to-GDP ratio have eroded much of the federal government's policy flexibility – including its ability to use discretionary policy to buffer the economy from the negative effects of recessions. This became abundantly clear in the 1990-1991 recession when the government was forced to offset the negative impact of the automatic stabilizers on the deficit to prevent the debt-to-GDP ratio from rising.

The inequities of high debt

The imperative of lowering a high debt-to-GDP ratio is not only a matter of economics and fiscal accounting. It is also a matter of fairness toward future generations.

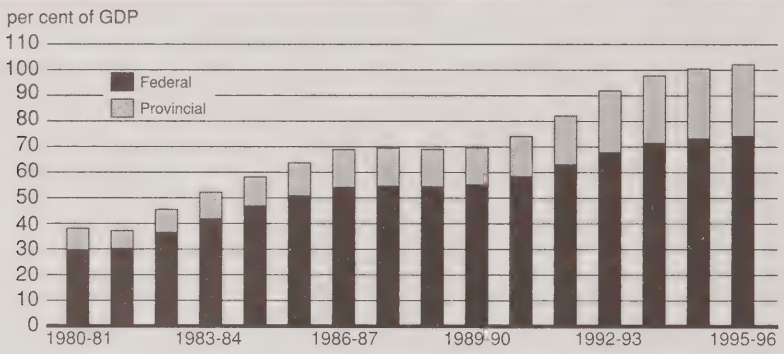
Canada, in particular, will face major demographic changes in the next century. Over the next 40 years, the percentage of the population over 65 will almost double to 22 per cent, from 12 per cent today. At the same time, the share of the population of working age will decline. Thus the ratio of dependants – both elderly and children – to the working-age population will increase, from about 48 per cent now to over 60 per cent.

Adjusting to these changes alone will pose a considerable challenge. The additional burden of having to act to reduce the debt-to-GDP ratio should not be imposed on future generations as well. Those working now should not leave an enormous debt for future generations to pay.

Federal fiscal situation more severe than at provincial level

Since the early 1990s, the deterioration in federal finances was compounded by a similar deterioration in provincial finances. The all-province debt-to-GDP ratio increased from under 15 per cent to 28 per cent between 1989-90 and 1995-96 (on a Public Accounts basis). This meant that the combined federal-provincial debt-to-GDP ratio exceeded 100 per cent in 1995-96 (Chart 2.7).

Chart 2.7 Net debt: federal and provincial governments (Public Accounts basis)

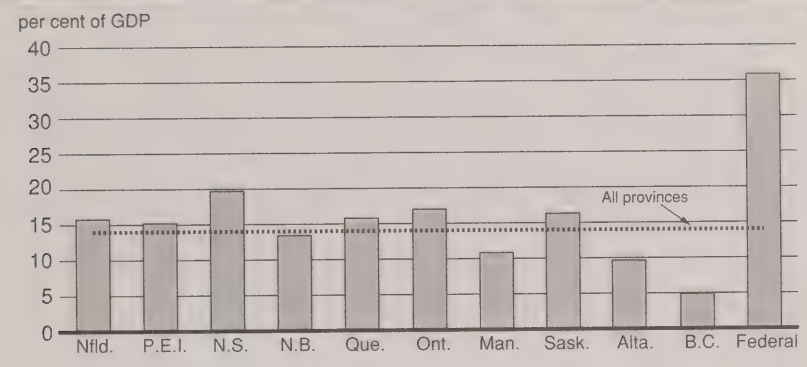


However, the combined provincial fiscal situation is not as difficult as that at the federal level. Although the provincial debt-to-GDP ratio has nearly doubled in the past five years, its level in 1995-96 is still only about one-third of the federal ratio. The provincial debt-to-GDP ratio now is similar to the level that the federal ratio was in 1980-81.

The much lower debt-to-GDP ratio for the provinces means that less of their revenues must go to paying debt servicing costs (Chart 2.8). On an aggregate basis, debt servicing costs amounted to 14 cents of each revenue dollar that the provinces received in 1995-96 (which includes revenues received from the federal government). It ranged from about 5 cents in British Columbia to 20 cents in Nova Scotia. This compares to 36 cents for the federal government.

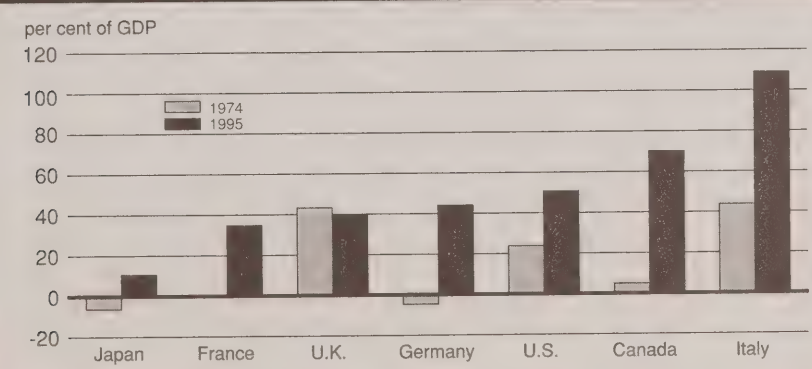
The run-up in the debt-to-GDP ratio in Canada was not unique among G-7 countries. Other countries also experienced increases in their debt-to-GDP ratios over this period. But few were as pronounced as in Canada (Chart 2.9). Canada moved from having a relatively low debt-to-GDP ratio in 1974 to having the second highest among the world's seven largest economies in 1995. (Debt-to-GDP ratios by country are traditionally reported on a National Accounts basis in order to allow comparability across countries. The debt-to-GDP ratio on a National Accounts basis is significantly smaller than on a Public Accounts basis but the trends are broadly consistent. See Annex 2.)

Chart 2.8 Interest on debt as a per cent of budgetary revenues: provinces and federal government (1995-96)



All-province total includes territories.

Chart 2.9 Total government net fiscal debt – G-7 countries (National Accounts basis)



Source: *Statistics Canada* for Canada; *OECD* estimates for other countries.

Meeting the challenge

The government's top priority is to ensure strong and sustained job creation and economic growth, while protecting the most vulnerable in Canada.

To achieve this overarching goal, the government has focused on three key objectives:

- creating a healthy fiscal and economic climate by eliminating the deficit and reducing the debt-to-GDP ratio;
- reforming Canada's social programs in order to ensure that they are sustainable over the long run; and
- providing Canadians and Canadian business with the support they require to take full advantage of the opportunities in the modern economy.

These objectives are mutually reinforcing:

- cleaning up the nation's finances will lead to lower interest rates, which will bolster economic growth and job creation and, in turn, further improve the fiscal situation;
- structural changes to support and enhance the economy's growth potential will lead to more jobs and higher incomes. This, in itself, lowers the debt-to-GDP ratio by increasing GDP. But in the longer run, it also increases revenues to the government which reduces the deficit, providing another source of downward pressure on the debt ratio. (The government's strategy to enhancing economic growth is explained in Chapter 5.)

Anchored by a healthy fiscal and monetary climate

Creating a healthy fiscal and monetary climate is a prerequisite for achieving the government's economic and social objectives.

Governments by themselves cannot ensure ongoing job creation – the private sector is the engine of economic growth. If the economic foundation is weak, due to high interest rates or a lack of competitiveness or other forces that diminish risk taking, then no amount of government employment initiatives would be successful enough to offset the shortfall in job creation in the private sector.

The *approach* to restoring fiscal health has been two-track: reducing expenditures and fostering economic growth. There have been no personal tax rate increases in any of the last three budgets. Tax measures have been targeted largely at closing loopholes and increasing tax fairness.

Budget planning has been based on:

- setting two-year rolling deficit targets as a step to achieving its ultimate objective of a balanced budget. In the past, the fact that fiscal targets were set for the long term played a role in delaying the implementation of needed fiscal reforms;
- using prudent economic planning assumptions, that are somewhat more conservative than the average of private sector economic forecasts; and
- including a Contingency Reserve, as an additional amount of prudence to ensure that the deficit targets will be met.

The contingency reserve is included in the deficit projection primarily to cover risks arising from (i) unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and (ii) unpredictable events. The contingency reserve also provides an extra measure of back-up against adverse errors in the economic forecast. **The contingency reserve is not a source of funding for new policy initiatives.**

The fiscal actions

The 1994 budget created savings to put the deficit on a downward path. It was the first of a two-step process that culminated with the 1995 budget, that introduced the most far-reaching reform of federal spending in the postwar era. The 1996 budget extended and consolidated the savings achieved in the previous two budgets.

Together, the three budgets put in place savings that will build to $29 billion annually by 1998-99, of which close to 90 per cent are the result of expenditure reductions (Table 2.2). These savings will result in a 14-per-cent decline in program spending between 1992-93 and 1998-99. In relation to the size of the economy, program spending by 1998-99 will be at its lowest level since 1949-50.

Table 2.2
Direct budget savings

	1994-95	1995-96	1996-97	1997-98	1998-99	Cumulative effect on net debt
			(billions of dollars)			
1994 budget	1.5	8.0	10.9	11.9	12.6	44.9
1995 budget		5.0	10.6	13.3	13.8	42.7
1996 Employment Insurance (EI) reform[1]				0.7	0.8	1.5
1996 budget				0.2	1.7	1.9
Total	1.5	13.0	21.5	26.1	28.9	91.0
of which:						
expenditures	0.7	10.6	18.9	23.3	25.6	79.0
revenues	0.8	2.4	2.6	2.8	3.4	12.0

[1] Savings for 1996-97 were included in 1995 budget savings.

Resulting in a more effective federal government ...

The cornerstone of the 1995 and 1996 budgets was *Program Review* – a comprehensive review of departmental spending whose objective was to bring about a more effective and cost-efficient way of delivering programs and services to Canadians. This Review will fundamentally change what government does and how it operates. The changes have already begun.

A new *Expenditure Management System* has been introduced to better control government spending by ensuring better accounting of cost and risk and that new policy initiatives are now funded through spending reallocation.

Program delivery has also been reformed to increase efficiency and effectiveness. For example, the 1996 budget announced the creation of a Single Food Inspection Agency to consolidate food inspection and quarantine-related services currently provided in three federal departments into one single agency. The federal government has also been discussing with the provinces the establishment of a federal-provincial border and revenue service to eliminate existing overlap and duplication in tax administration.

The government is privatizing or commercializing services that the private sector is better positioned to deliver. For example, all of the government's shares in Canadian National Railways and a substantial portion of the government's interest in Petro-Canada have been sold.

The government is also getting out of activities that have been shown to impede adaptation and innovation. By 1998-99, subsidies to business will have declined 61 per cent from their level in 1994-95. The structure of remaining subsidies will be shifted away from direct production subsidies toward income stabilization and economic adjustment in Canadian agriculture, support for small business development and promoting technological advancement and the competitiveness of Canadian industry. Program assistance directed to business development will be on a more commercial basis, including more risk sharing by the private sector and repayable forms of assistance.

These and other changes are bringing about a sharp drop in departmental spending. By 1998-99, departmental spending will be 21.5 per cent lower than in 1994-95 (Table 2.3).

However, Program Review has not only reduced spending, it has reallocated spending to the government's highest priorities. Reductions in departmental spending have been less severe in departments dealing with *social, justice* and *legal* issues – reflecting the priority given to issues related to justice, health care and aboriginals.

... and a more affordable and sustainable transfer system

Departmental spending accounts for less than half of federal program spending. No spending reform could be sufficient without an examination of the transfer system to individuals and to other levels of government – these latter transfers represent about 23 per cent of program spending. The government's three budgets have reformed transfer programs to make them more sustainable over the long run and more suited to the needs of the current and future generations:

- significant changes have been made to Canada's Employment Insurance (EI) system;
- the proposed reform of seniors benefits will take effect in 2001 in order to be mature when the "baby boomers" reach retirement. In addition, the proposed reform will fully protect the benefits of all current and near seniors;
- the federal government and the provinces are currently discussing reform of the Canada Pension Plan (CPP) system to ensure that the system is sustainable for the future; and

Table 2.3
Departmental spending

	Spending levels		Change	
	1994-95	1998-99	$ million	Per cent
	(millions of dollars)			
Natural resource-based programs	5,524	3,564	-1,960	-35.5
Agriculture	2,080	1,455	-625	-30.1
Fisheries and Oceans	1,307	1,037	-269	-20.6
Natural Resources	1,422	592	-830	-58.4
Environment	716	480	-236	-32.9
Transport	2,273	704	-1,569	-69.0
Industrial, regional and scientific-technological support programs	3,822	2,760	-1,062	-27.8
Industry	2,940	2,052	-888	-30.2
Regional agencies	882	708	-174	-19.7
Justice and legal programs	3,375	3,140	-236	-7.0
Justice	752	719	-33	-4.5
Solicitor General	2,623	2,421	-202	-7.7
Heritage and cultural programs	2,906	2,051	-855	-29.4
Foreign affairs and international assistance	4,374	3,232	-1,142	-26.1
Foreign Affairs and International Trade	1,464	1,320	-143	-9.8
International Assistance Envelope	2,910	1,912	-998	-34.3
Social programs	12,641	11,664	-971	-7.7
Citizenship and Immigration	658	615	-43	-6.5
Health	1,818	1,682	-136	-7.5
Human Resources Development	2,415	1,452	-964	-39.9
Indian and Northern Affairs	3,786	4,268	481	12.7
Canada Mortgage and Housing	1,988	1,808	-180	-9.0
Veterans' Affairs	1,975	1,840	-136	-6.9
Defence/Emergency Preparedness	11,801	9,252	-2,549	-21.6
Parliament and general government services	4,635	3,979	-656	-14.1
Central agencies	369	248	-122	-32.9
Total	51,720	40,593	-11,127	-21.5

Source: 1996 budget estimates.

■ transfers to provinces for health, social welfare and post-secondary education have been reduced to be more affordable and restructured to be more predictable and more flexible. The five-year financing arrangement announced in the 1996 budget will take effect in 1998-99, and includes the assurance of a minimum $11-billion cash transfer. Provincial transfer entitlements will begin to increase by the turn of the century. Territorial transfers have also been reformed to increase the incentives for economic development within the territories.

The results: dramatic improvement in the federal deficit

The fiscal results for 1994-95 and 1995-96 show that the prudent approach to budget planning is paying off. The deficit targets were bettered in both years (Chart 2.10).

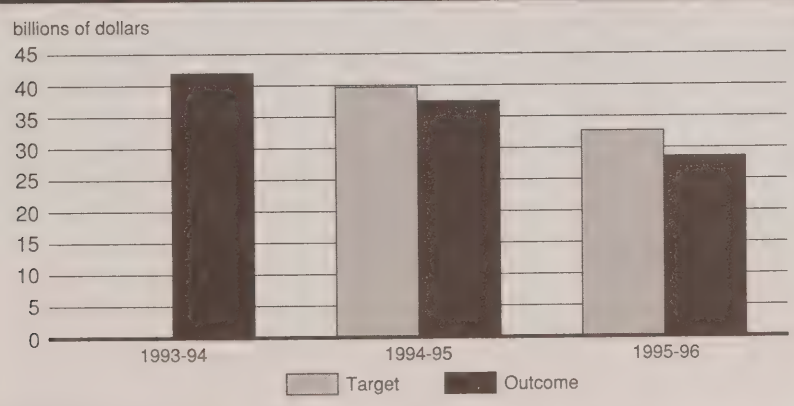
1994-95

The deficit for 1994-95 was $37.5 billion – $4.5 billion lower than the deficit in the previous year and $2.2 billion below the target of $39.7 billion set out in the 1994 budget.

1995-96

The deficit for 1995-96 was $28.6 billion – $8.9 billion less than the 1994-95 deficit. In relation to the size of economy, the deficit in 1995-96 was 3.7 per cent – its lowest level since 1976-77.

Chart 2.10 Federal deficit: outcome and target (Public Accounts basis)



The deficit was about $4 billion lower than the target of $32.7 billion set out in the 1994 budget. Budgetary revenues were marginally lower than assumed in the 1996 budget, while public debt charges were relatively unchanged. However, departmental spending was reduced more quickly than anticipated in the 1996 budget. As a result, the operating surplus was $18.3 billion. For the second consecutive year, the contingency reserve was not required.

Details on the deficit results for 1995-96, are provided in the *Annual Financial Report of the Government of Canada – Fiscal year 1995-96.*

Federal improvement has been complemented by the provinces

Federal progress has been complemented by the actions of the provinces in addressing their deficit situations. By the end of 1995-96, 7 of the 12 provincial/territorial jurisdictions had balanced their budgets or were running surpluses, while the remaining provinces have all committed to balancing their budgets by the end of the decade, if not earlier.

Table 2.4
Provincial/territorial deficits
(millions of dollars and as a per cent of GDP)

	1993-94		1994-95		1995-96	
	Dollars	Per cent of GDP	Dollars	Per cent of GDP	Dollars	Per cent of GDP
Nfld.	205	2.2	127	1.3	-4	0.0
P.E.I.	71	3.1	1	0.0	-4	-0.2
N.S.	547	3.0	235	1.3	201	1.1
N.B.	290	2.0	64	0.4	-51	-0.3
Que.	4,894	3.0	5,710	3.4	3,966	2.3
Ont.	11,202	3.9	10,129	3.4	8,726	2.8
Man.	430	1.8	196	0.8	-156	-0.6
Sask.	272	1.3	-128	-0.6	-18	-0.1
Alta.	1,384	1.8	-958	-1.2	-1,132	-1.3
B.C.	910	1.0	446	0.5	235	0.2
Yukon	-15	-1.8	-29	-3.4	-1	-0.1
N.W.T.	36	1.8	26	1.2	31	1.3
Total	20,228	2.8	15,819	2.1	11,793	1.5

Note: a negative number indicates a budgetary surplus.

Source: Provincial budgets; Public Accounts.

3

The Economic Payoff and Planning Assumptions

Introduction

The government has been pursuing monetary and fiscal policies aimed at achieving low and stable interest rates as the basis for renewed growth and job creation. The payoffs from this strategy are now beginning to appear: interest rates have come down substantially in the last 18 months and the economy is beginning to respond.

Continued low inflation, the progress that all levels of government have made in addressing their fiscal problems and the turnaround in the current account from deficit to surplus have allowed the Bank of Canada to ease monetary conditions substantially since the 1995 budget. Short-term interest rates have dropped over 450 basis points since the spring of 1995 and, in fact, have been below those in the U.S. since March.[1]

Low interest rates spurred the economy on to a strong performance in 1994. The pace of economic activity weakened significantly, as interest rates moved sharply higher in 1995 when U.S. rates rose and the Canadian dollar came under severe pressure in foreign exchange markets. The effects of higher interest rates continued to impair economic growth in early 1996. But the interest rate declines that have been recorded since 1995 should again provide a strong boost to the economy's performance in 1997.

[1] All numbers as of Friday, October 4, 1996.

The improved outlook is already evident in the data. The housing sector is beginning a healthy recovery with house resales very strong and housing starts up well above last year's level. Business confidence is up sharply and, as a result, investment intentions for 1996 have been revised up. Consumer confidence has improved since the beginning of the year. Real GDP rose 0.5 per cent in July alone.

For fiscal planning purposes, the government will continue its practice of adopting prudent economic assumptions. This approach was developed following the advice from the Round Table of private sector economists held in December 1993, and the recommendations of the House of Commons Standing Committee on Finance. They recommended that budget planning be based on interest rate assumptions above the average of private-sector forecasts and, as a result, lower nominal GDP. The purpose of this approach was to guard against the possibility that a less favourable economic environment might derail the government's fiscal plan.

Recent developments in Canada: the payoff to date

Strong foundations

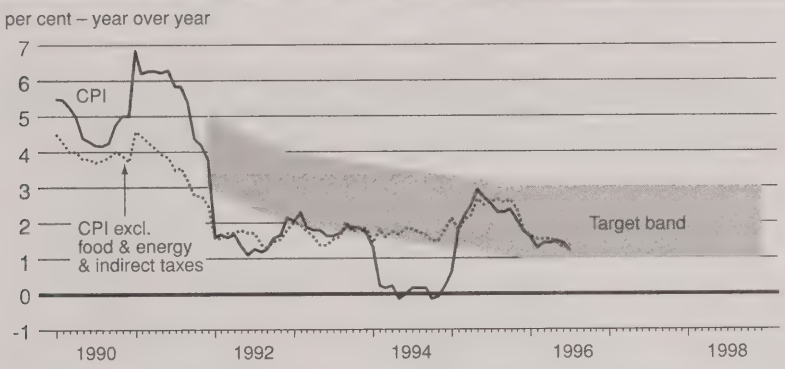
The fundamentals for a resumption of healthy growth – particularly low interest rates – are now coming into place. The substantial declines in Canadian interest rates reflect Canada's low inflation and improved trade and current accounts performance, in addition to the substantial progress on the fiscal front at all levels of government.

Inflation remains low

As expected, inflation has come down sharply since 1995, despite some pressure from a temporary rise in energy prices in early 1996. Since December 1995, the Consumer Price Index (CPI) inflation rate has been in the lower half of the Bank of Canada's target range of 1 to 3 per cent (Chart 3.1). In part, this reflects continued modest wage growth. This has restrained unit labour costs, which have grown by less than one-half per cent per year since the beginning of 1991.

The other major factor contributing to the slowdown in inflation has been a sharp reduction in the growth of import prices over the last year. Commodity prices have eased significantly after a strong run-up in 1993 and 1994, easing the pressures on producer prices. As well, the depreciation of the dollar between late 1991 and early 1995 which contributed to strong increases in the prices of imported goods has been followed by a year of stability for the Canadian dollar. Over the past year, the dollar has traded in a fairly narrow band of between 72½ and 74½ cents U.S. As a result, the prices of imported consumer goods have remained relatively stable.

Chart 3.1 Consumer Price Index



Canada's trade performance has improved sharply

Low inflation, combined with the depreciation in the dollar since the early 1990s, has improved Canadian competitiveness enormously. This has led to a sharp improvement in the merchandise trade surplus – from one-half per cent of GDP in 1991 to roughly 5.0 per cent of GDP in the second quarter of 1996.

Improvements in the trade sector are broadly based. Growth in merchandise exports has been exceptionally strong (Chart 3.2). Only about a quarter of the rise is attributable to commodity exports. Growing exports of manufactured goods, including autos and machinery and equipment, accounted for the rest. In dollar terms, exports of machinery and equipment are now almost as important as automotive exports.

Tourism has also benefited from the improvement in Canadian competitiveness. The balance on the travel account has improved significantly since the beginning of 1991 (Chart 3.3).

Chart 3.2 Merchandise trade surplus

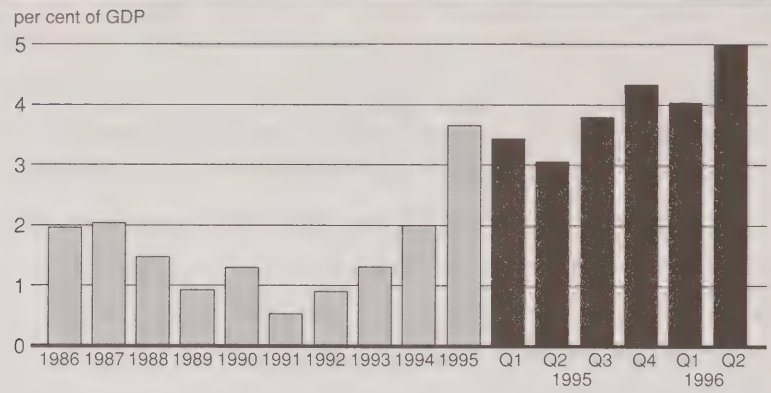
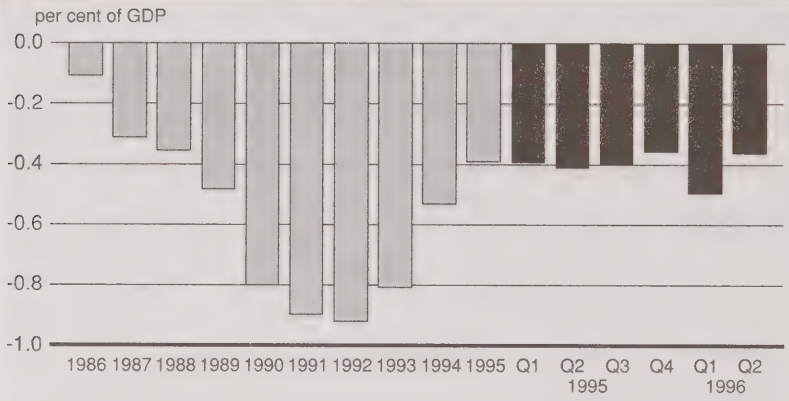
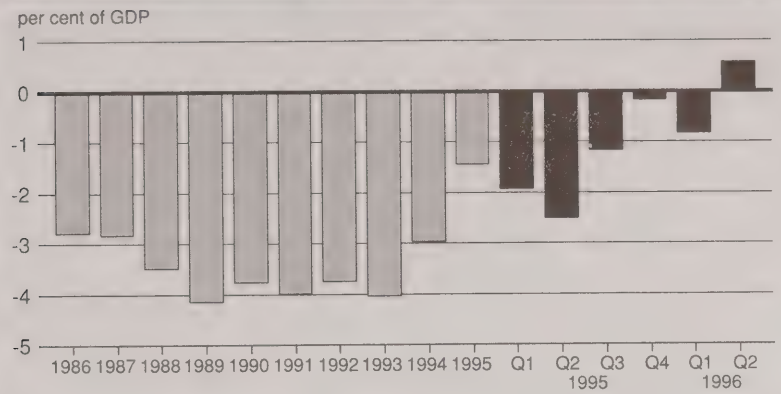


Chart 3.3 Travel balance



The strong performance of the trade sector over the past few years has led to a huge turnaround in the current accounts balance (Chart 3.4). The current account has moved from deficits averaging around 4 per cent of GDP in the early 1990s to a surplus of about 0.6 per cent of GDP in the second quarter of 1996, the first surplus that the current account has registered in 12 years.

Chart 3.4 Canada's current account balance



Interest rates are down substantially

Getting the fundamentals right has helped to boost financial market confidence. This has allowed the Bank of Canada to pursue a substantial easing of monetary conditions, with 17 reductions in the Bank Rate over the past 17 months. Although short-term U.S. interest rates increased modestly over the spring and summer, owing to concerns about re-emerging U.S. inflation pressures, these rates have since fallen back to their January levels. Short-term Canadian interest rates, meanwhile, have declined steadily over the year (Chart 3.5). They have been below those in the U.S. since late March, the first sustained period of negative spreads since 1983 (when the negative spreads were not as large and lasted for only 14 weeks) (Chart 3.6).

Chart 3.5 3-month Treasury bills

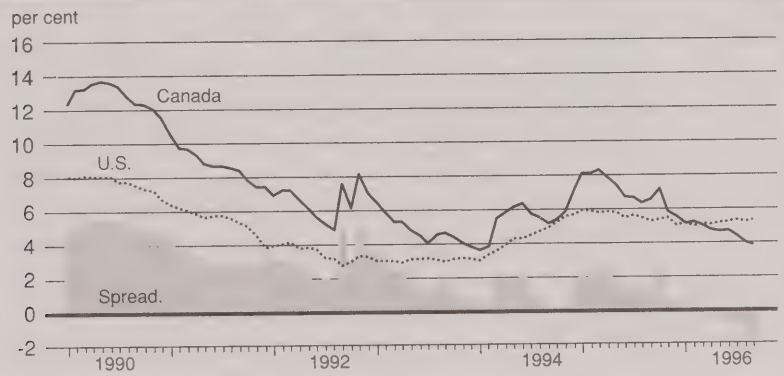
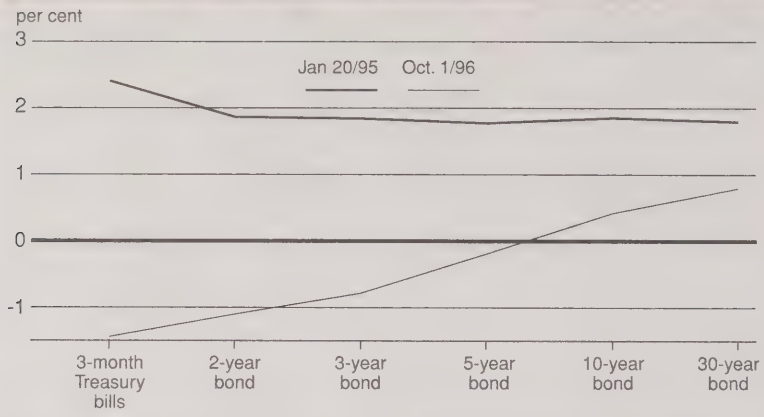
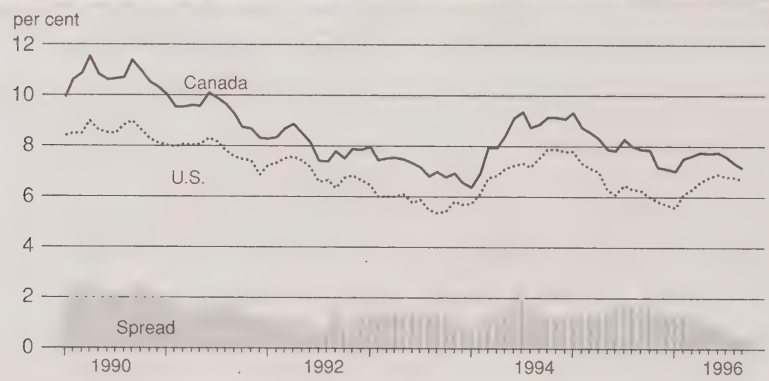


Chart 3.6 Canada-U.S. interest rate spreads



In the U.S., yields on 10-year government bonds, which had been declining since early 1995, have risen about 110 basis points since the beginning of 1996 (Chart 3.7). Rates on Canadian bonds also initially moved upward early in the year, but fell subsequently, with the result that Canadian rates are now roughly where they were at the start of the year. The spread between Canadian and U.S. long-term rates is now less than one quarter a percentage point ... 150 basis points less than one year ago. Nonetheless, the Canadian yield curve is unusually steep by historical standards. The difference between 3-month Treasury bills and 10-year benchmark government bonds is currently around 350 basis points, well above its historical average of about 90 basis points.

Chart 3.7 10-year government bond



Demand is strengthening and production growth will follow ...

The unexpected weakness in both foreign and domestic demand at the beginning of 1995 had left businesses with unusually large stocks of unsold goods. Over the second half of 1995 and the first half of 1996, overall demand was recovering, but output growth lagged the demand increases as businesses sought to reduce inventories to more normal levels. This slowed employment growth and, hence, growth in personal incomes and household expenditures.

This period of slow growth appears to be behind us, however, and growth should strengthen considerably in the rest of 1996 and into 1997.

- First, lower interest rates are boosting both consumer and business confidence and there are signs that a robust recovery is beginning in the interest-sensitive sectors of the domestic economy. The rebound is particularly evident in the housing market where sales of existing homes are up, unsold inventories are down and housing starts and building permits are rising. Business investment intentions for 1996 have also been revised upwards. Businesses now expect private non-residential investment spending to rise 4.4 per cent in 1996, a much stronger performance than the 2.3-per-cent decline they were expecting at the beginning of the year.

- Second, the inventory clearance now appears largely complete, particularly after the large inventory reduction in the second quarter of 1996. As a result, production growth should follow more closely the growth in demand in the coming months.

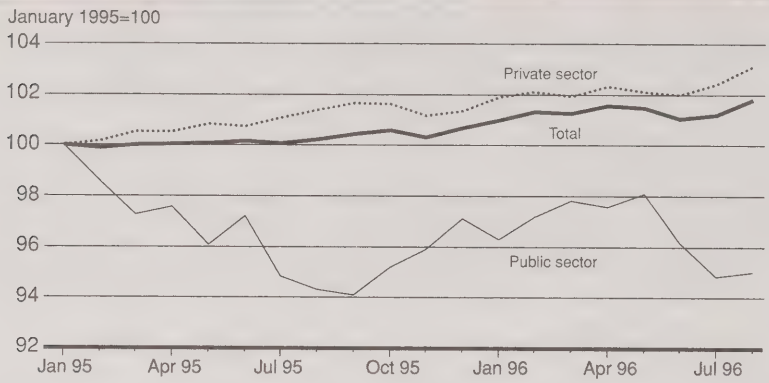
... and stronger growth will support job creation

The weakness in overall employment growth masks a fairly strong job-creation performance by the private sector. Since last November, 220,000 jobs have been created in the private sector. This was partly offset by a loss of 19,000 jobs in the public sector (Chart 3.8).

The shift of jobs from the public to private sector reflects a major restructuring of the domestic economy. The government sector has shrunk 2.2 per cent since the end of 1994, while the business sector has grown 2.2 per cent.

Despite this restructuring, overall GDP growth has picked up to around 1¼ per cent at an annual rate so far in 1996. Recent indicators support the view that the economy will strengthen in the second half of 1996.

Chart 3.8 Employment growth by sector



The outlook: updating the planning assumptions

The external environment

Major overseas economies

Growth in the main European countries in 1996 is expected to be below the levels registered in 1995, especially in France and Germany. Europe's sluggish economies are expected to pick up in response to both the easing in monetary conditions to date and an assumed further easing over the remainder of 1996. In Japan, the signs of strength now evident in the economy are expected to be a harbinger of better economic performance: real GDP is projected to grow 2.8 per cent in 1996 and 2.4 per cent in 1997, about three times the pace registered last year. Despite the pick-up in growth, inflationary pressures are expected to remain well contained in the major overseas economies.

The United States

After a period of sluggish growth through most of 1995, the U.S. economy rebounded in the first half of 1996. Real GDP grew 2.0 per cent in the first quarter despite the GM strike, the severe January weather, and the government shutdown, and 4.7 per cent in the second quarter. Clearly, the

U.S. economy cannot continue to grow at this unsustainable pace. The rise in long-term interest rates earlier this year, the stronger dollar, higher consumer debt, and fiscal restraint are operating in the direction of a slower pace of growth. The consensus view is that economic activity will moderate to near its long-run potential growth rate of just over 2 per cent by the end of this year, a rate that is also expected to prevail in 1997 (Table 3.1).

The consensus view is, however, that the momentum evident in the economy will likely lead to the Federal Reserve increasing the federal funds rate 25 basis points from its current level of 5.25 per cent by the end of the year. The federal funds rate is then assumed to remain unchanged.

Because of the slowdown in economic activity in the second half of this year and growth at around potential rates in 1997, CPI inflation is forecast to stay near its current level of 3 per cent.

Table 3.1
Economic assumptions for the U.S. – Private sector average

	1995	1996	1997
Real GDP	2.0	2.4	2.2
CPI	2.8	3.0	3.0
90-day Treasury bill rate (true yield)	5.7	5.3	5.5
10-year government bond rate	6.6	6.5	6.6

Source: Blue Chip Economic Indicators September 10, 1996. This is a survey of approximately 50 U.S. private sector forecasters. The 90-day bill rate has been adjusted from a discount basis by the Department of Finance.

The economic assumptions for Canada

Private sector sees low inflation and strong growth ahead

Private sector forecasters expect that Canada's advantageous competitive position will keep export growth healthy over the remainder of this year and next year even as the U.S. economy slows to a more sustainable pace of growth. Just as importantly, the substantial declines in domestic interest rates are expected to help strengthen domestic demand considerably in the second half of 1996. This will help stimulate job creation, growth in household incomes and consumer confidence, further boosting dometic demand.

As a result, private sector forecasters expect that the level of output will be about 2¾ per cent higher at the end of 1996 than it was at the end of 1995 – a sharp improvement relative to the 0.7-per-cent expansion during 1995 (Table 3.2). This implies that the average level of real GDP in 1996 will be 1.5 per cent above that in 1995.

Private sector forecasters expect that this momentum will carry through 1997, leading to stronger employment growth and a fall in the unemployment rate. They expect the CPI inflation rate to rise slightly in 1997 to just under the mid-point of the Bank of Canada's target inflation range. They also expect short-term Canadian interest rates will move up somewhat in 1997 with U.S. rates.

Table 3.2
Change in the average private sector forecast

	1995	1996	1997
Real GDP growth (%)			
February 1996	2.5	1.9	2.8
September 1996	2.3	1.5	3.1
Nominal GDP growth (%)			
February 1996	4.3	3.5	4.6
September 1996	3.9	2.7	4.6
Nominal GDP ($ billion)			
February 1996	782	809	846
September 1996	776	797	834
CPI inflation rate (%)			
February 1996	2.2	1.7	2.1
September 1996	2.2	1.5	1.7
Unemployment rate (%)			
February 1996	9.5	9.4	9.1
September 1996	9.5	9.5	9.2
Employment growth (%)			
February 1996	1.6	1.3	1.8
September 1996	1.6	1.4	1.9
91-day Treasury bill (%)			
February 1996	7.1	5.3	5.8
September 1996	7.1	4.5	4.5
10-year benchmark government bond rate (%)			
February 1996	8.1	7.2	7.4
September 1996	8.1	7.6	7.5

The February private sector average is based on 20 respondents for 1996 and 18 for 1997; it was carried out before the release of the Canadian Income and Expenditure Accounts for the fourth quarter 1995. The September survey is based on 15 respondents for both years, a somewhat smaller sample than usual as it includes only forecasters who have updated their forecasts since the release of the second quarter National Accounts data on August 30.

The changes in private sector views since the 1996 budget range from the small to the substantial. The smaller changes are that the outlook for real growth in 1996 has been marked down slightly but that for 1997 has been marked up and that the private sector now expects lower inflation this year and next. Historical data revisions and lower inflation forecasts also contribute to the lower level of nominal GDP in current private sector forecasts. The substantial changes are the major downward revisions to the outlook for short-term interest rates, revisions which help explain why forecasters now expect even stronger real growth in 1997. In contrast to the outlook for short-term rates, longer-term rates are expected to be slightly higher than projected at the time of the 1996 budget, reflecting the increases in the first half of the year that were primarily attributable to higher U.S. rates.

The favourable assessment of Canada's economic prospects underlying private sector forecasts is shared by major international organizations. The International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD) both expect strong growth in the second half of 1996, followed by sustained robust growth in 1997 and beyond. Indeed, the IMF recently released its *World Economic Outlook* showing that Canada is expected to outgrow all the G-7 economies in 1997.

Prudent assumptions for fiscal planning

In the prudent planning alternative, short-term interest rates are assumed to be 80 basis points higher than the private sector average in 1997. Long-term interest rates, meanwhile, are assumed to be 50 basis points higher than the private sector forecast. These assumptions result in lower growth in nominal GDP in the prudent planning alternative, with nominal GDP growth 0.2 per cent lower than the private sector average (Table 3.3).

The prudence factors on interest rates reflects two key considerations.

- There remains a risk that continued strong growth expected in the U.S. will elicit a greater-than-expected tightening of monetary conditions by the Federal Reserve Board, and hence, higher U.S. interest rates by year

end or early 1997, which could spill over to Canada. Prudent planning therefore dictates that we provision for short-term interest rates well above those expected by the private sector.

■ However, the prudence factor on long-term interest rates is somewhat smaller than that applied to short-term rates. The Canadian yield curve is unusually steep; that is long-term rates are much higher than short-term rates than is usually the case. This may reflect some lingering worries on the part of investors concerning the sustainability of our low inflation performance of the past couple of years, especially as growth strengthens. While the unusual steep slope of the yield curve is consistent with the view that short-term rates could move higher in the near term, it offers the prospect that Canadian long rates may not rise commensurably with short-term rates as investors revise downward their expectations of future inflation. As a result, a somewhat lower prudence factor is appropriate.

Table 3.3
Change in prudent economic assumptions for fiscal planning

	1995	1996	1997
Real GDP growth (%)			
1996 budget	2.2	1.8	2.6
October update	2.3	1.5	3.0
Nominal GDP growth (%)			
1996 budget	4.0	3.3	4.3
October update	3.9	2.7	4.4
Nominal GDP ($ billion)			
1996 budget	780	806	841
October update	776	797	832
91-day Treasury bill (%)			
1996 budget	7.1	5.8	6.6
October update	7.1	4.5	5.3
10-year benchmark government bond rate (%)			
1996 budget	8.1	7.7	8.2
October update	8.1	7.6	8.0

1996 budget assumptions for 1995 interest rates are actual data.

Relative to the planning assumptions in the 1996 budget, short-term interest rates are lower, while long-term interest rates are broadly unchanged in 1996 and 1997. The level of nominal GDP, however, is down by about $9 billion in 1996 and 1997. This is due in part to historical data revisions, which should have relatively little impact on the fiscal outlook. The rest reflects a downward revision to the real growth outlook for 1996, although this is mostly offset by a stronger growth for 1997, and slightly lower inflation outlook.

4

Creating a Healthy Fiscal Climate: Continuing the Progress

Fiscal implications of the economic assumptions: changes to the 1996 budget track

Chapter 3 provided an update of the economic developments in the past year and sets out the economic assumptions that could be used in planning the 1997 budget. This chapter describes the fiscal implications of these economic assumptions, showing that the government is on track to meet its deficit targets and to set the debt-to-GDP ratio on a steady downward path. This chapter also describes in more detail the significant improvement that is underway in Canada's fiscal situation and the challenges that will have to be met to keep this improvement continuing.

1996-97

The deficit target for 1996-97, as first announced in *Creating Opportunity*, is 3 per cent of GDP, or $24.3 billion. This has been a major anchor in the government's strategy of achieving a balanced budget.

Nominal income in 1996 – the tax base for budgetary revenues – is now expected to be lower than assumed in the 1996 budget. This is because of revisions to the historical level of nominal GDP in 1995 and lower-than-assumed real growth and inflation in 1996.

The revisions to the historical estimates of nominal income for 1995 have no fiscal counterpart, as revenues for 1995-96 are already known. However, the lower-than-expected real growth and inflation outcome in the first half of 1996 and the consequent impact on nominal income will reduce forecast revenues. This is especially true for personal income taxes and excise taxes and duties.

In contrast, corporate income tax collections are expected to be higher-than-projected in the March 1996 budget, largely because of the much higher-than-expected outcome for 1995-96.

On balance, budgetary revenues are expected to be about $1.6 billion lower in 1996-97 than projected at the time of the 1996 budget. Program spending is now projected to be $0.3 billion lower.

Interest rates for 1996, especially short-term interest rates, have been much lower than assumed in the 1996 budget. As a result, public debt charges are now estimated to be $1.3 billion lower than projected in the 1996 budget.

Table 4.1
Changes to the 1996 budget deficit track

	1995-96	1996-97	1997-98
	(billions of dollars)		
March 1996 budget deficit track	-32.7	-24.3	-17.0
Changes:			
Revenues			
Personal income tax	0.3	0.9	0.7
Corporate income tax	-1.6	-1.0	-0.6
Excise taxes and duties	1.0	0.7	0.7
Other	0.7	0.9	1.0
Total revenue changes	0.3	1.6	1.9
Program spending			
Transfers to persons	-0.2	-0.1	-0.1
Transfers to other levels of government	-0.3	-0.2	-0.3
Other spending	-1.3	–	–
Total spending changes	-1.7	-0.3	-0.4
Public debt charges	-0.1	-1.3	-1.5
Contingency Reserves	-2.5	0.0	0.0
Total changes	-4.1	0.0	0.0
Revised deficit with unchanged policy	-28.6	-24.3	-17.0

Note: Negative sign indicates a reduction in the deficit. Positive sign means an increase in the deficit. Numbers may not add due to rounding.

Overall, lower public debt charges and program spending offset the lower budgetary revenues, leaving the deficit target of $24.3 billion on track.

Financial results to date support this conclusion. The deficit over the April to August 1996 period was $5.4 billion lower than in the same period in 1995-96. About $1.8 billion of this improvement was the result of developments unique to the first quarter of 1996-97. This includes higher tax remittances related to the 1995 taxation year, the timing of Goods and Services Tax collections and the manner in which some of the budget restraint measures are being implemented. These special factors mean that an assessment of the possible outcome for the year as a whole cannot simply be extrapolated from the improvement in the results to date.

Nevertheless, the results to date clearly indicate that the 1996-97 deficit target will be met and possibly bettered.

1997-98

The deficit target for 1997-98 of $17 billion, or 2 per cent of GDP, set out in the 1995 *Economic and Fiscal Update* and restated in the 1996 budget, also remains on track. Expenditure savings required to ensure the achievement of this target were contained in actions announced in both the 1995 and 1996 budgets.

Budgetary revenues are now expected to be $1.9 billion lower than forecast in the 1996 budget – entirely due to the lower forecast of nominal income. Within budgetary revenues, lower personal income tax collections, excise taxes and duties, and non-tax revenues more than offset higher corporate income tax collections. For planning purposes, the employee employment insurance premium rate in 1997 is assumed to be $2.90 per $100 of insurable earnings – the same as in the 1996 budget. In 1996, the rate was $2.95 per $100 of insurable earnings.

Program spending is expected to be $0.4 billion lower than in the 1996 budget.

Offsetting the weaker revenues are lower public debt charges, related to lower short-term interest rates than assumed at the time of the 1996 budget.

Table 4.2
Summary statement of transactions: status quo fiscal extension

	1995-96[1]	1996-97	1997-98
	(billions of dollars)		
Budgetary revenues	130.3	133.5	139.1
Program spending	112.0	108.8	105.6
Operating balance	18.3	24.7	33.5
Public debt charges	46.9	46.5	47.5
Underlying deficit	-28.6	-21.8	-14.0
Contingency Reserve	–	2.5	3.0
Deficit	-28.6	-24.3	-17.0
Net public debt	574.3	598.6	615.6
Non-budgetary transactions	11.4	10.6	11.0
Financial requirements	-17.2	-13.7	-6.0
GDP (calendar year)	776	797	832
Per cent of GDP			
Revenues	16.8	16.8	16.7
Program spending	14.4	13.7	12.7
Operating balance	2.4	3.1	4.0
Public debt charges	6.0	5.8	5.7
Deficit	-3.7	-3.0	-2.0
Financial requirements	-2.2	-1.7	-0.7
Net public debt	74.0	75.1	74.0

[1] Actual.

Continuing the progress

The government's ultimate objective is job creation and growth. The government's two-track approach – cleaning up the nation's finances, and ongoing structural reforms and strategic investments to further enhance the growth potential of the economy – will ensure increased confidence in Canada's economic future.

The pace that the government has chosen to achieve this result is measured, deliberate and responsible. Responsible fiscal action requires careful planning, appropriate time for adjustment to policy changes (both inside and outside government), and consideration of the economic impact of reductions in government spending.

Central to the government's fiscal strategy has been a two-year planning horizon. This strategy recognizes that the fiscal projections are simply too sensitive to economic developments to warrant a longer time frame.

Just as importantly, the two-year horizon is short enough to maintain the government's focus on ensuring that the targets are achieved; the costs of missing the deficit targets are simply too high.

This strategy is working. The deficit has been brought down from $42.0 billion, or 5.9 per cent of GDP in 1993-94, to $28.6 billion in 1995-96, or 3.7 per cent of GDP. The fiscal targets for 1996-97 and 1997-98 clearly remain on track.

Consistent with the two-year fiscal planning horizon, it is now appropriate to establish the deficit target for 1998-99.

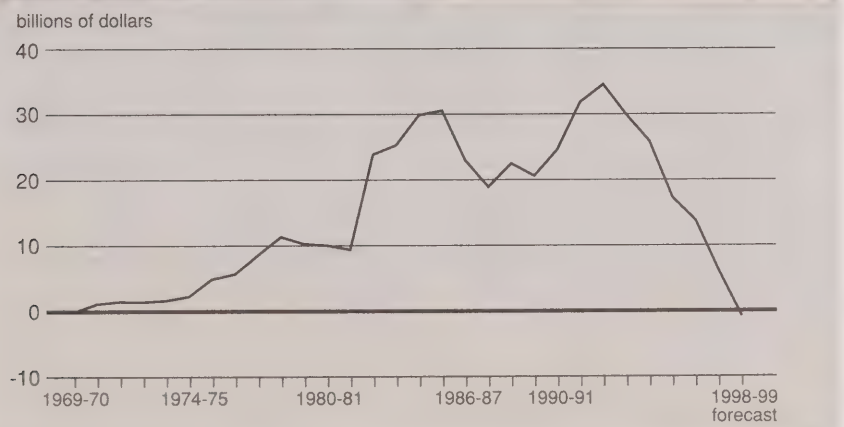
To build on the progress made to date and in line with the measured pace of deficit reduction established in the last three budgets, the deficit target for 1998-99 will be $9 billion or about 1 per cent of GDP. The last time the federal deficit was under $10 billion was 1976-77. The last time the deficit in relation to the size of the economy was about 1 per cent was in 1970-71.

The structural reforms that were put in place in the last three budgets will keep program spending on a downward track, and together with prudent economic planning assumptions mean that the deficit target in 1998-99 can be achieved.

Financial requirements eliminated by 1998-99

A deficit target of $9 billion for 1998-99 will mean that the government will not have to go to the private credit markets for new borrowing, other than that required to roll over the existing stock of debt (Chart 4.1). The last time this occurred was in 1969-70.

Chart 4.1 Financial requirements



Financial requirements, which measure the amount by which cash going out from the government exceeds cash coming in – and which is more comparable to how most other G-7 countries calculate their deficits – will be in a small surplus position by 1998-99.

The Deficit and Financial Requirements

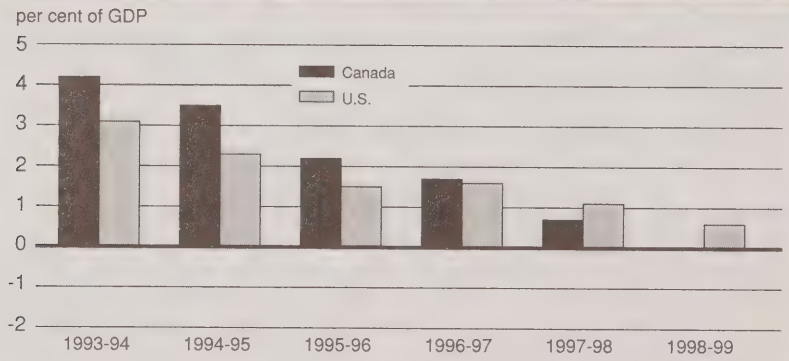
The difference between the deficit and financial requirements is due to a number of non-budgetary transactions that provide funds to the government. The largest of these is the government's employees pension accounts. Other small sources of funds include loans, investments and advances, cash in transit and accounts payable. These differences are explained in detail in Annex 2.

Fiscal position improving faster in Canada than in the United States

Financial requirements are more comparable to the way most central governments in major economies measure their *deficits*. For example, the United States deficit on a unified budget basis (UBB) is more comparable to Canada's financial requirements than the Canadian budgetary deficit.

Comparisons with the United States are particularly important for Canada because of the substantial interdependence between the two economies. In addition, the capital markets within the two countries are highly integrated, with the result that fiscal policies in the U.S. can have financial repercussions for the Canadian economy.

Chart 4.2 Financial requirements: Canada and U.S.



Note: Financial requirements for Canada; United Budget Basis deficit for the U.S.
Source: U.S. forecast from Mid-Season Review of the 1997 Budget (OMB).

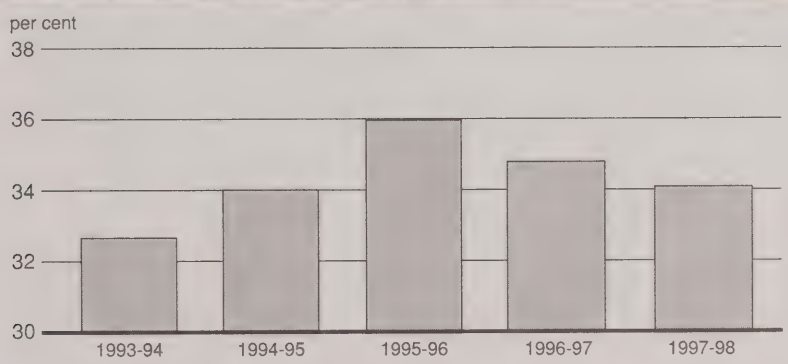
Canada's deficit, as measured by financial requirements in relation to GDP, has been falling much more rapidly than the U.S. government deficit in recent years (Chart 4.2).

Federal debt-to-GDP ratio will stabilize then fall

As noted in Chapter 2, declining deficits are only one measure of fiscal recovery. The crux of the fiscal problem in Canada is high debt, and the most appropriate indicator of this is the debt-to-GDP ratio. A key milestone on the road to restoring Canada's fiscal health will be reached in 1997-98. Following two consecutive decades of virtually uninterrupted increases, the debt-to-GDP ratio will start to decline. And the target of reducing the deficit to $9 billion in 1998-99 will ensure that the ratio will continue to decline after 1997-98.

As the debt-to-GDP ratio declines, the share of federal revenues needed to pay debt charges will also decline (Chart 4.3). However, the burden of the debt on the economy will remain high by historical Canadian and international standards. A sustained period of operating surpluses will be required before the debt-to-GDP ratio declines significantly.

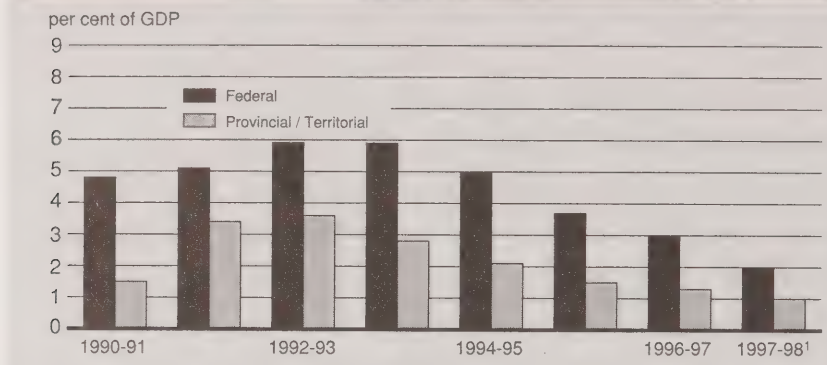
Chart 4.3 Interest on the debt as a per cent of budgetary revenues



Federal fiscal improvement complemented by provincial-territorial sector

The improvement in federal finances is being complemented by a similar effort at the provincial level. The combined provincial-territorial deficit has declined since 1992-93, from 3.6 per cent of GDP to 1.6 per cent of GDP in 1995-96 (Chart 4.4).

Chart 4.4 Federal and provincial-territorial budgetary deficits (Public Accounts basis)



[1] Forecast

Further progress is anticipated for 1996-97, with seven provinces expected to report balanced budgets or budgetary surpluses. Like the federal government, many provincial governments have also focused on reducing spending to achieve their fiscal targets.

However, because the federal fiscal imbalance was more serious than that of the provinces, the federal government has had to take significantly more fiscal action. For example, between 1993-94 and 1996-97, the percentage decline in federal program spending will be about three times larger than the percentage decline in total provincial program spending.

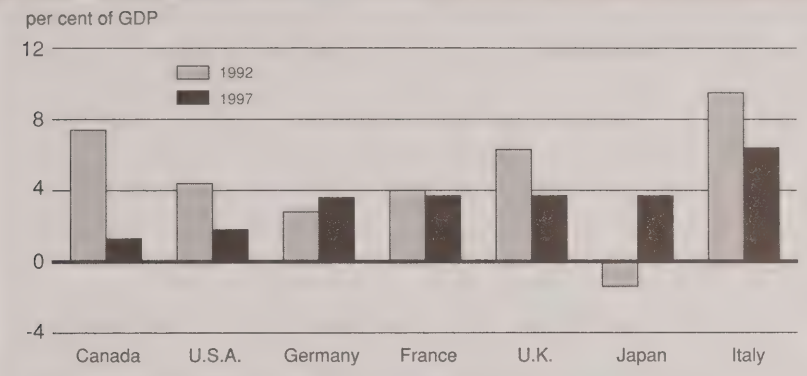
The coherence between federal and provincial fiscal strategies has resulted in an impressive decline in the total government deficit. From a peak of 9.6 per cent of GDP in 1992-93, the total government sector deficit is forecast to decline to some 3 per cent of GDP in 1997-98 (Public Accounts basis).

Fiscal improvements in total government sector also compare very favourably internationally

Among G-7 countries that have undergone fiscal consolidation over the last two decades, the improvement in Canada's total government fiscal balance on a National Accounts basis will have been the most substantial. From 1992 to 1997, the total government deficit in Canada will have moved from being the second highest among the G-7 countries to the lowest, at 1.3 per cent of GDP (Chart 4.5).

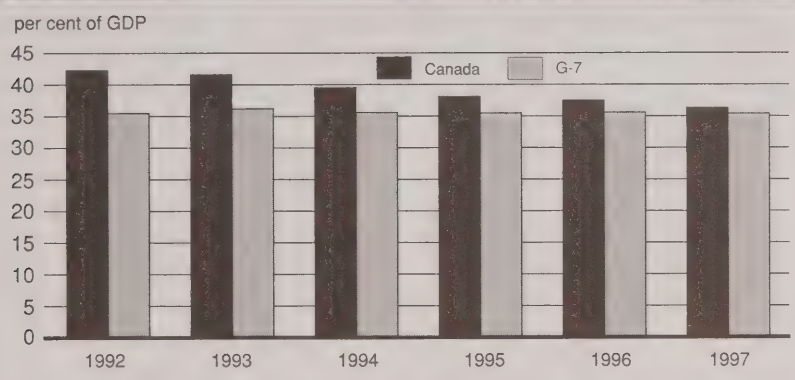
This improvement primarily reflects the impact of reductions in program spending. In 1992, program spending by all levels of government in Canada, as a share of GDP, was about 5 percentage points above the G-7 average (Chart 4.6). By 1997, it will be similar to the G-7 average.

Chart 4.5 Total government deficit in G-7 countries (National Accounts basis)



Source: Department of Finance for Canada, OECD Economic Outlook Data for other G-7 countries.

Chart 4.6 Total government program spending (National Accounts basis)



Source: Department of Finance, G-7 Average, OECD Economic Outlook Data, 1996.

The ongoing challenge of restoring fiscal sovereignty

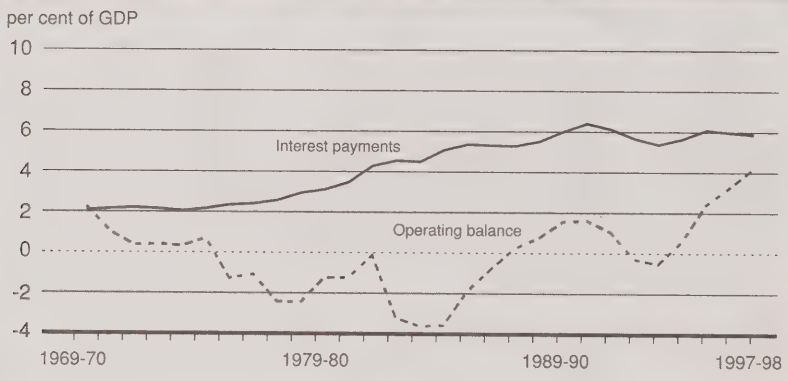
The fiscal actions already put in place will result in a sharply lower deficit. However, the federal debt-to-GDP ratio will remain high by historical and international standards. Prudent fiscal management will be required for

some time yet if the government's ultimate fiscal objectives – a balanced budget and a significant reduction in the debt-to-GDP ratio – are to be achieved.

The operating reserve required to lower the debt-to-GDP ratio will depend on the evolution of interest rates and the growth in the economy. For illustration, suppose that from now on the government were to achieve and maintain an operating surplus equivalent to 5 per cent of GDP. This is higher than the surplus expected in 1997-98 of about 4 per cent of GDP (Chart 4.7). Under prudent economic assumptions, an operating surplus of 5 per cent of GDP would lower the debt-to-GDP ratio by 10 percentage points after 5 years – from 74 per cent to 64 per cent.[1] This would be a significant drop, but it would leave the debt ratio at about its level in 1991-92. Sustained large operating surpluses will be required before the debt-to-GDP ratio is reduced to a more manageable level.

The policy decisions necessary to eliminate financial requirements have now been taken and have put the government on track toward eliminating the deficit. The challenge now and for the future is to reduce significantly the debt-to-GDP ratio.

Chart 4.7 Public debt charges and operating balance



[1] This example assumes that nominal GDP growth is 3.5 per cent and the effective interest rate on the debt is 8 per cent.

5

Supporting Job Creation

Introduction

The federal government's top economic priority is clear: more and better jobs for Canadians. However, in a modern economy, sustained job creation must be generated by the private sector. That does not mean government has no role to play. On the contrary, government has a *critical* role to play in supporting job creation. The federal government has embraced that role through its Jobs and Growth Strategy as outlined in the 1994 *Agenda: Jobs and Growth* documents. This strategy addresses both immediate and long-term job creation needs through several key components:

- setting the appropriate macro-economic conditions to keep interest rates low and encourage investment;
- getting government right to ensure that government programs and policies contribute to a more productive economy (which is discussed in Chapter 2);
- creating opportunities for Canadian businesses to grow by selling in the world economy;
- investing in growth through strategic investments in new technology, in worker skills, and in capital, such as infrastructure; and
- helping Canadians adapt by encouraging them to adjust to the changing economy, helping small businesses grow and prosper, reducing the regulatory burden on business and ensuring that Canada has an efficient, secure and competitive financial sector.

Canada is not alone in adopting such a strategy. Indeed, the Organization for Economic Co-operation and Development (OECD) recommended, in its own *Jobs Study*, that all industrialized economies adopt this approach.

Setting healthy macro-economic conditions

The issue

No economy can perform well without healthy macroeconomic conditions. In particular, strong growth – which leads to strong job creation – plays an essential role in helping the economy adapt to the major structural changes that are occurring.

A healthy macroeconomic climate is one where inflation is low and stable, where fiscal deficits and debt are under control, and where interest rates – that is the cost of capital – are low and stable. A healthy macroeconomic climate enhances consumer and business confidence, encourages domestic and foreign businesses to expand their activities in Canada and to undertake investments in new capital and technologies. It also encourages both businesses and workers to invest in needed education and skills.

It is the responsibility of governments to establish a healthy economic climate by keeping inflation low and stable, and by getting and keeping their fiscal house in order.

The policies

Low Inflation

Canadian economic policy has led to a sustained period of low inflation. Inflation has averaged under 2 per cent in the last three years – its lowest sustained level in three decades and less than one-third of its average during the 1980s.

Canada has not been alone in pursuing the benefits of low inflation. In 1995, inflation in the G7 countries averaged 2.4 per cent, compared to 5.6 per cent in the 1980s. The record shows that – in the long-run – economies with low and stable inflation perform better than economies with high and variable inflation. In particular, countries with sustained low inflation tend to have lower unemployment.

Getting government finances in order

For several years, however, Canada's fiscal situation prevented the full benefits of our excellent inflation performance from being realized. For instance, short-term interest rates were over 1 percentage point higher in Canada than in the U.S. in 1994, although inflation in Canada was about 2½ percentage points below that in the U.S. This was, in large part, because of investors' concerns about governments' abilities to meet their financial commitments if they continued to build up debt by running high fiscal deficits.

This kept interest rates high for all borrowers in Canada. Those high real interest rates discouraged business investment and consumer spending. One only has to look at Canada's depressed housing market in 1995 to see the impact. High real rates also worsened the fiscal situation. The weakened economy slowed revenue growth while interest costs rose. This vicious circle had to be broken by a determined effort to cut fiscal deficits.

This shows that deficit reduction and debt control is not an end to itself but rather *an integral part of the government's jobs and growth strategy*. All Canadian governments recognize the importance of fiscal prudence and have been successfully reducing their deficits.

The payoff

The payoff is already evident. Investors' confidence in Canada has substantially improved and, as a result, the risk premium in Canadian interest rates has been reduced. For example, in 1994, many investment firms were recommending that their clients reduce their Canadian investments. But, by 1996, they were reversing their positions and telling investors to substantially increase their holdings of Canadian assets.

The resulting declines in interest rates since early 1995 have pushed Canadian short-term rates well below those in the U.S. These lower interest rates encourage consumers to buy and businesses to invest by lowering the cost of borrowing or raising capital. The decline in mortgage rates has contributed to more than a 15-per-cent increase in housing starts and almost a 50-per-cent increase in existing housing sales since their troughs in 1995. The payoff is also evident in business confidence, which is also up strongly to one of its highest levels since the end of the 1970s, and in the recent increases in investment intentions.

Creating opportunities for growth through trade

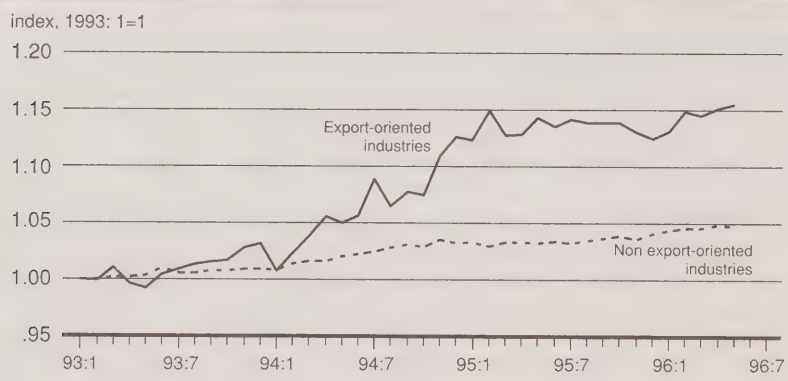
The issue

Creating and sustaining a positive macroeconomic environment is vital for creating more and better jobs. But it is only part of the story. Improving access to foreign markets, as has been achieved under NAFTA and the World Trade Organization (WTO), and capturing the expanded export opportunities, are also vital for job creation.

Canadians have always been trade oriented. Selling our products and services around the world has generated jobs, increased wealth, and brought all Canadians a higher standard of living. *This is as true today as it has been throughout Canada's history.* In fact, the dramatic growth in exports in recent years has been the strongest single contributor to Canada's economic growth and job creation.

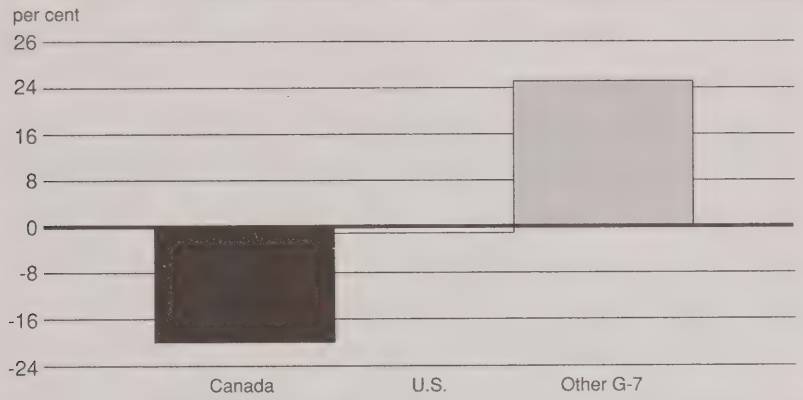
However, many Canadians remain concerned that freer trade increases competition, and that this threatens job security. There is no doubt that the growth in world trade has had adverse effects on some businesses and some workers. This is the nature of change and has been part of Canada's economic development for decades. While imports have at times displaced production in Canada, the resulting job losses have been more than offset by the employment gains from increased exports (Chart 5.1). Trade liberalization has consistently been positive for the overall Canadian economy, and it is the export-oriented industries which have seen the healthiest rate of job creation.

Chart 5.1 Employment growth by trade orientation



Most of Canada's foreign trade, and most of the recent growth in our trade, is with other industrialized countries that have wages and other costs similar to or even higher than those in Canada. For example, in 1995, 80 per cent of Canada's exports went to the U.S. and 75 per cent of our imports came from our southern neighbour. In the same year, 12 per cent of our exports went to, and 16 per cent of our imports came from other OECD countries, almost all of which are highly industrialized. Declines in Canada's unit labour costs relative to these countries since 1991 have improved Canada's competitiveness, and contributed both to export growth and job creation (Chart 5.2).

Chart 5.2 Change in manufacturing unit labour costs since 1991 (measured in a common currency)



Only 9 per cent of Canada's imports come from other areas, most of which are lower-wage developing countries. While competition from these countries can lead to job losses in some firms and companies, on balance Canada has been more than able to compete with these countries. With the advantages of our increasingly skilled work force, our use of technology and our physical and social infrastructure, Canadian workers are significantly more productive than workers in lower wage developing countries. For example, studies have shown that, although wages in Canada are as much as seven times higher than those in Mexico, Canadian workers, because of their higher productivity, remain very competitive with Mexican workers.

Furthermore, the liberalization of international trade gives Canadian producers access to larger markets. That allows them to specialize in what they do best and to become both more efficient and more competitive. In turn, Canadians have access to better-quality goods and services at lower prices, which also raises our standard of living.

The policies

To preserve and increase this key source of growth and job creation, governments must support the private sector in securing and expanding Canada's access to world markets for its goods and services. This includes pursuing trade liberalization through multilateral and bilateral trade agreements, implementing measures to assist companies develop and expand their export business, and bolstering awareness of Canada's advantages as a location for investment.

Trade agreements

Canada has been, and remains, at the forefront of efforts to strengthen the global rules-based trading system and to liberalize trade. Canada was a key participant in the recent Uruguay Round of multilateral trade negotiations which resulted in the establishment of the World Trade Organization to oversee and guide the expansion of world trade. The OECD has estimated that the WTO agreement will increase the national incomes of those participating by about $320 billion. This increased income creates new demand for goods and services, leading to higher employment. For Canada, it is estimated that real annual incomes of Canadians from the WTO agreements will increase by $3 billion in perpetuity.

Following the conclusion of the Uruguay Round, a WTO agreement in financial services was reached under the auspices of the *General Agreement on Trade in Services* (GATS). The agreement involves over 90 countries. Canadian financial institutions, many of which are important exporters, will benefit from the agreement as a result of its provisions for broad-based trade disciplines and as a result of the enhanced trade liberalization commitments by other countries to open their financial markets. This will provide greater opportunities for Canadian financial institutions to offer competitive financial services worldwide.

Canada has also signed a free-trade agreement with Israel and has undertaken negotiations to establish an agreement with Chile to expand access to each others' markets. In addition to pursuing further avenues for trade liberalization and strengthening the rules-based trading system, the government will continue to act vigorously to challenge unfair trade practices by others and defend Canadian trade interests in disputes about Canadian practices, such as in softwood lumber.

Team Canada trade missions

A key part of the focus on trade is the Team Canada trade missions. The two Team Canada missions plus the trade mission to Latin America in the past year and a half have brought home some $20 billion worth of business deals for Canadian companies and created or sustained thousands of jobs. As a result of this success, more Team Canada missions are planned for the future.

Helping Canadian Business Export

The Jobs and Growth Strategy is helping prepare companies for export opportunities through initiatives such as:

- the ***International Business Opportunities Centre***, established last fall, has already helped almost 6,000 Canadian companies access new business opportunities from around the world;
- a market research centre has been established to provide market intelligence and other information to exporters to strengthen our ability to compete in foreign markets;
- twenty-three national sector teams of public and private sector representatives are working together to devise action plans to target international business development more effectively;
- the federal government has reduced tariffs on a wide range of goods to reduce costs and help Canadian manufacturers become more competitive in domestic and world markets. (In 1996, the reductions in tariffs since 1994 will save Canadians $1.9 billion.) Other tariff-related measures have provided administrative and cash-flow savings to Canadian exporters.

More export financing

Access to competitive export financing often determines whether or not a firm can export. In the 1996 budget, the Export Development Corporation (EDC) was provided with $50 million of additional capital to support new approaches to export financing and to create new partnerships with exporters and commercial banks.

In September, the EDC committed an additional $1.5 billion in new export financing to support sales of Canadian goods and services to foreign customers in 50 higher-risk emerging markets worldwide. This is only the latest in a series of steps to help exporters to successfully break into international markets.

Other EDC Initiatives

- Since 1993, the EDC has opened or reopened nearly 20 new markets in which it provides export financing.
- The EDC recently announced less restrictive coverage for short-term credit insurance for exporters to 33 markets.
- The EDC has also created specialized teams which focus on small- and medium-sized enterprise (SME) exporters and have developed a number of specialized products and services for them.

Attracting international investments

More than one job in 10 and more than half of Canada's exports are directly due to international investment in Canada. The Jobs and Growth Strategy is helping to attract high quality, technology-rich international investments to Canada. In particular, Canada's improved macroeconomic climate and much improved competitive position has made the country one of the *top ranked* countries in the world in which to invest.

Tax policy also plays an important role in maintaining Canada as an attractive location for investment and job creation. It is of particular importance that Canada maintains a competitive tax regime in relation to its major trading partner, the United States. All levels of government have a role to play here.

The payoff

Businesses are increasingly finding that Canada is a cost-effective place to invest in and produce from. As a result, Canadian exports have grown much faster than imports. The payoff is obvious in the numbers.

- In 1995, foreign direct investment as a per cent of GDP reached its highest level since 1980.
- The volume of Canada's exports has soared, up 28 per cent since the end of 1993. In 1995, 42 per cent of the real value of Canadian production was exported, making Canada the most export-oriented of the G-7 economies.
- As a result, Canada has experienced a dramatic $19-billion improvement in its real trade balance since the end of 1993, an improvement which led to a current account surplus in the second quarter of 1996 – the first since 1984.
- This improvement in Canada's international trade balance has created about 275,000 jobs for Canadians in the past 2½ years.

Investing in growth

A healthy macroeconomic climate and expanding opportunities for trade are both key ingredients for a strong economy. But, the role of government does not end there. There is also a key role for governments in helping businesses and their workers seize the opportunities for growth created by growing world trade and advances in technology. Canada's success at world trade has not been built on a foundation of low wages. Instead, it has been built on a foundation of up-to-date technology, an educated and skilled workforce, and a high level of investment to make the economy more productive. Together these factors allow Canada to be competitive with high wages, even by the standards of most industrialized economies. Further productivity growth in Canada will sustain and increase these wages.

Thus, no job strategy would be complete without the government acting to ensure that Canada retains and enhances its competitive advantages in technology, worker skills and capital. The government has been targeting its assistance on strategic investments that promise the greatest long-run benefits. Reflecting the primary role of businesses in creating jobs, many initiatives are in partnership with the private sector.

Investing in technology

The issue

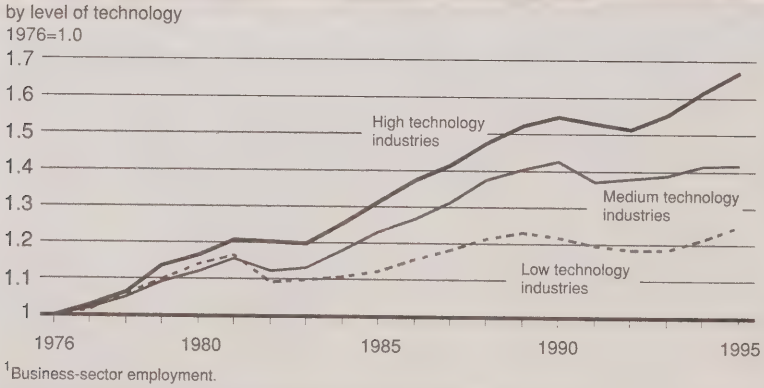
One of the key goals of the Jobs and Growth Strategy is the development of technology. Technology enhances competitiveness. It delivers new products and services, more product choice and lower prices. This creates new demand for goods and services, both in Canada and abroad, creating more and better paying jobs.

People are often concerned that improvements in technology result in the replacement of workers by machines. While new technology does tend to reduce the amount of labour needed to create a given product, there is overwhelming evidence that the resulting higher quality of products and lower production costs leads to a net increase in jobs. As the OECD *Jobs Study* states:

> *"Empirical analysis based on cross-country comparisons tends to confirm the fact that the employment record has been better in those countries which have experienced the best performance in terms of pace of structural change, technological specialization, investment rates and productivity gains."*

In other words, those who willingly embrace technology and use it create more jobs. This has been very evident in Canada, where, from 1976 to 1995, employment in industries that used high-technology inputs intensely grew more than twice as fast as employment in low-technology industries and 60 per cent faster than in medium-technology industries (Chart 5.3).

Chart 5.3 Growth in employment[1]



[1]Business-sector employment.
Industries are classified by the high-tech share of their non-labour inputs.

The policies

The Jobs and Growth Strategy is helping Canadian businesses become more adept at developing and using technology. Many of these initiatives involve partnerships with the private sector and other levels of government.

Helping to Develop Technology

- Businesses are encouraged to create new technology and processes with one of the most generous tax treatments of research and development in the world.
- Through ***Technology Partnerships Canada***, the federal government will invest approximately $250 million by 1998-99 to lever additional investment from the private sector in strategic high-tech sectors of the economy. Under this initiative, the government treats its funding as a key strategic investment rather than a grant. The funds are to be reimbursed when the products in which they were invested are a success. The reimbursements are returned to the fund to help finance additional projects.
- In the 1996 budget, the government injected almost $50 million into the ***Business Development Bank of Canada***. This funding will leverage an additional $350 million in bank loans to Canadian small business and growing knowledge-based, export-oriented businesses.
- The development of the ***Information Highway*** is another critical link in the Jobs and Growth Strategy, crucial to the competitiveness of Canadian businesses and their ability to create jobs. The government is actively promoting the development of the Canadian portion of the global information highway and working to ensure Canadians get access to the Information Highway through programs such as the ***Community Access Program***.
- The ***Industrial Research Assistance Program*** (IRAP) provides professional advice, technological know-how and financial support to small- and medium-sized companies that want to strengthen their R&D capabilities.
- ***Sectoral Partnerships*** bring together business, labour and government to promote standards for workers' skills and training to meet the needs of the dynamically evolving market.

Investing in education and skills

The issue

Educated and skilled workers are also an essential part of the Jobs and Growth Strategy. Without a qualified workforce, it is hard to generate or even use the latest in technology. There are two ways governments can help Canadians get the education and skills they need for the modern economy.

- The first is to invest in the education of Canada's young people and help them with the all-important transition from school to work.
- The second is to help those who are in the labour force to upgrade their education and skills, especially those who have lost their jobs and are having difficulties getting reintegrated into the labour market.

The policies

Investing in youth

One of the priorities of the Jobs and Growth Strategy is ensuring that Canada's youth have the education and opportunity to participate in building Canada's future by finding meaningful jobs – especially that critical first job that bridges the gap between school and work.

Loans and Tax Assistance for Education

- Under the Canada Student Loans Program, the government supports more than $1 billion in new student loans each year to help students to advance their post-secondary education. On August 1, 1995, the government made a series of major reforms to this program which provided $85 million in additional assistance to students who most need it.
- In the 1996 budget, the federal government provided an additional $80 million a year in tax assistance to help students and their families deal with the rising costs of higher education:
  - the amount on which the education credit is based was increased from $80 to $100 per month;
  - the limit on the transfer of tuition and educational amounts was increased from $4,000 to $5,000;
  - the annual limit on registered education savings plan contributions was increased from $1,500 to $2,000.
- The eligibility for the Child Care Expense Deduction was expanded to allow single parents or both parents who attend school full time to claim the deduction against all forms of income.

The first step is to help young people get a good education. That's why the government has set aside additional funding to help young Canadians to finance their education and get summer jobs.

The second step is to help young Canadians find work and make the transition from school to work. To do so the government allocated an additional $315 million, over three years, for youth programs in the 1996 budget.

- The government doubled – to $120 million in 1996-97 – the assistance provided for student Summer Career Placements. In total, about 60,000 summer jobs were created this year.

Assisting the Transition to Work

- Since 1994, ***Youth Service Canada*** has funded over 360 projects, involving over 5,200 young people in community service activities.
- ***Youth Internship Canada*** has helped almost 26,000 young people make the transition from school to work.
- The ***Student Connection*** program has 2,000 students responsible for training managers at 50,000 Canadian companies on how to use the Internet as a business tool.

Helping existing workers retrain

The vast majority of people who will be in the Canadian workforce in the year 2000 has already passed through the formal education system. Many of them will, however, need further education and skills upgrading. In many cases, the best way for them to get those skills will be through on-the-job training, as designed and implemented by the provinces in partnership with the private sector.

Governments have both the obligation and responsibility to help these people upgrade their skills. The Government of Canada has offered to negotiate agreements with interested provinces and territories to allow them to take responsibility for active employment measures funded through the Employment Insurance (EI) Account. These arrangements will focus on achieving mutually agreed labour market results in a manner reflecting the concerns of the provincial or territorial government. Negotiations with

the provinces and territories are now underway led by the Minister of Human Resources Development. This proposal offers an unprecedented opportunity for new federal-provincial partnerships in developing labour-market arrangements that are tailored to reflect regional and local needs.

For the first time, all active measures funded through the EI account will be subject to consistent and rigorous results-based measurements. As a result, governments will be able to ensure active measures are well targeted to address the unique employment challenges and requirements of specific groups, such as youth. Further, Human Resources Development will work to expand the national labour market information and exchange system.

Employment Initiatives with EI Reform

Approximately $2 billion will be made available in discussions with provinces and territories for results-oriented employment measures which could include:

- *targeted wages subsidies* that encourage hiring and provide on-the-job experience that will lead to long-term employment or re-employment;
- *targeted earnings supplements* that will make work pay for individuals making the transition back into employment;
- *self-employment assistance* that helps start businesses and create jobs for others;
- *job-creation partnerships* between the provinces, the private sector and communities that will create work opportunities where there is high unemployment; and
- *skill loans and grants* to let individuals make their own choices about what skills they need.

Investing in infrastructure

The issue

Another important role for government is to support initiatives and activities where the benefits are so widespread that no individual firm or government would undertake the activity alone because they would not get all the benefits. Infrastructure investment is such a case.

The policies

The $6-billion *Canada Infrastructure Works* partnership between federal, provincial and municipal governments was launched on December 21, 1993 in response to the widespread need to upgrade and renew municipal infrastructure. A recent evaluation report estimates that about 80,000 additional person years of work will be created over the duration of the program.

Other Infrastructure Initiatives

- The ***First Nations Infrastructure Initiative*** which addresses infrastructure priorities in First Nations communities and creates jobs for Aboriginal peoples.
- The ***Federal Buildings Initiative*** which is an innovative program to encourage federal departments to improve energy efficiency. Private-sector firms pay the up-front costs of energy-saving retrofitting and the government then repays them out of its initial energy savings. The end result is greater energy efficiency and lower government energy bills, at no up-front cost to the government.
- The ***Western Grain Transportation Act Adjustment Fund***, which provides $140 million in 1996-97 and 1997-98 to develop infrastructure supporting western agricultural producers affected by the removal of the transportation subsidy for grain.

Helping Canadians adapt

Helping workers adjust to change

The issue

In addition to having education and skills, Canadians also need help adapting to the changing economy. In some cases, the help consists of increasing incentives to look for, find, and keep jobs. In many cases, the help must be more direct, through programs which ease adjustment.

The policies

The recent changes to the EI system will increase incentives to work. Rather than simply provide income support, the new system will offer unemployed Canadians the incentives and tools to find new opportunities. It represents the most fundamental restructuring of the system since the existing structure was introduced in 1971.

- Benefits will be more closely tied to work effort. They will be assessed in terms of total hours worked and total earnings over a fixed period, rather than the number of weeks worked. This will encourage people to work as much as possible.

As well, changes in EI premium rates and the maximum insurable earnings for EI since 1994 will effectively reduce employee and employer contributions by $1.8 billion in 1996. This is a significant reduction in payroll taxes that will lead to lower labour costs and increased employment.

The 1996 budget also increased the incentives to work through a substantial rise in the *Working Income Supplement* (WIS) from $500 to $750 in July 1997 and to $1,000 in July 1998. The WIS helps low-income parents enter and stay in the labour force by helping to defray some of the extra costs related to working. When fully phased in, the higher WIS will provide an additional $250 million annually to an estimated 700,000 low-income working families.

Other Programs to Help Canadians Adjust

- The ***Sectoral Partnerships Initiative***, which brings together employers, workers, educators and governments to address the challenges of a changing economy on a sector-by-sector basis.
- The ***Community Development Program***, which helps to create jobs in communities with severe labour market problems.

Helping small business grow

The issue

Small- and medium-sized enterprises (SMEs) are a critical element of the federal government's plan for Jobs and Growth. Small firms (with fewer than 50 employees) and self-employed entrepreneurs now make up 97 per cent of the businesses in Canada. Adding in firms with up to 300 employees covers over 99 per cent of the businesses in Canada. SMEs account for 55 per cent of Canada's employment and 60 per cent of Canada's output.

Initiatives to Help SMEs

- The ***Small Business Loans Act*** (SBLA) is designed to help new and existing small businesses obtain term loans from chartered banks and other lenders, to finance the purchase and improvement of fixed assets.
- The ***Business Development Bank of Canada*** (BDC) provides financial and management services to help create and develop small- and medium-sized businesses. Through it, a wide spectrum of specialized business counselling, training and mentoring services and financing options are made available to commercially viable business projects. BDC financing complements that of commercial financial institutions.
- The ***Canada Community Investment Plan*** (CCIP) will provide small businesses across Canada with the skills and resources to access the risk capital required to finance growth.
- ***Canada Business Service Centres*** (CBSC) provide Canadian business people with a wide range of information on government services, programs and regulations. Each CBSC offers a variety of products and services to help clients get quick, accurate and comprehensive business information.
- Small business especially can be hobbled by regulatory burdens. As a result, a variety of initiatives are underway with the private sector to reduce the regulatory and paper burden on businesses, especially small- and medium-sized businesses, and to set standards that will make it easier and less costly to conduct business in Canada.
- ***The $500,000 lifetime capital gains exemption*** for shares of qualifying small businesses encourages investment in small business, and can help small business owners to accumulate assets for retirement.
- ***Labour Sponsored Venture Capital Corporations*** (LSVCCs) facilitate access to capital for SMEs. The federal government, and most provincial governments, provide tax credits with respect to the acquisition of shares by individuals in LSVCCs, which has helped them accumulate a large pool of capital. LSVCCs are required over a number of years to invest most of these funds in SMEs.
- The ***Federal Income Tax System*** for small business is one of the most favourable in the world. It contains many provisions that benefit small businesses including a reduced corporate income tax rate, enhanced refundable research and development tax credits, and a $500,000 exemption for capital gains resulting from investments in small corporations. These measures provide additional funds to small businesses for reinvestment and increase their ability to access additional external financing.

While SMEs are a key source of job creation in this country, there are also important linkages between SMEs and larger firms in Canada which warrant attention. Restructuring of large corporations and governments has contributed to the rise in small businesses, as activities once done in-house are increasingly purchased from SMEs. As a result, Canada's large firms are the prime consumers of many of the services and products of Canadian SMEs, particularly in the export sector. In this context, the health and prosperity of Canada's large firms is also very important to the success and survival of Canadian SMEs.

The policies

The most appropriate policies are those which help small firms in areas where they have difficulty competing because of their size. This can include promoting international competitiveness through trade and investment, as well as through technology adoption, adaptation and development.

Financial sector policies

The issue

An efficient, secure and competitive financial sector is a critical component of job creation and growth. Canadians now enjoy one of the strongest financial systems in the world, and one which, with over 500,000 employees, is itself an important source of jobs. However, global and technological developments are posing complex challenges to this sector that must be addressed as we go forward.

The policies

The federal government has introduced proposals which call for important adjustments to the legislation for the financial sector. In addition, the government is establishing a *Task Force on the Future of the Canadian Financial Services Sector* with a broad mandate to make recommendations to enhance the contribution of the sector to job creation, economic growth and the new economy.

The payoff from the jobs and growth strategy

Clearly, there is no single "magic bullet" solution which can solve all Canada's economic problems at once. The solution lies in pursuing many policies – all with the one goal of more and better jobs. The Jobs and Growth Strategy has been doing that. It has put in place a process that has begun to reduce the cost of capital and will lead to improved productivity of Canadian businesses and workers by building a more dynamic and adaptive economy with a better-educated, better-skilled workforce. Such an economy will generate the growth and jobs Canadians need.

As a long-term strategy, much of the employment and growth gains from the strategy have yet to be realized. But the most recent numbers show the policy has already begun to pay off as Canadian interest rates come down and growth strengthens.

- About 670,000 jobs have been created since the end of 1993.
- Private sector job growth has been even stronger with nearly 770,000 jobs created over the same period of time.
- Since the fourth quarter of 1993, employment growth in Canada has been faster than in any other G-7 country except the U.S., where growth has been about the same.
- In fact, Canada has created more jobs than the combined total of Germany, France, Italy and the U.K. over this period, despite major restructuring of the public sector in Canada.

But this employment growth is still not good enough. The job gains in the private sector have been somewhat overshadowed by public sector losses as a result of the major restructuring of the federal and provincial sectors. As this restructuring matures, continued lower interest rates and a strong competitive private sector can be expected to strengthen total employment growth further. This is reflected in the June 1996 *OECD Outlook*, which forecasts that Canada will have the highest rate of job growth of any G-7 country in 1996 and 1997.

6

Conclusions and Main Issues

Considerable progress has been made in recent years in restoring fiscal health. The fiscal deficits, at both the federal and provincial levels, which seemed so intractable for many years, are now on a clear downward path. The actions taken in the last three budgets by the federal government will halt the rise in the federal debt-to-GDP ratio, and put it on a firm downward path. These achievements have created the necessary conditions for a substantial reduction in interest rates and for stronger economic growth and job creation.

The actions in the last three budgets restored credibility to federal government budget making. These actions addressed the immediate fiscal problem in a determined and measured way. But they went beyond the short term, ensuring that future spending pressures were being addressed now in a manner that ensures the sustainability of important social programs.

The government's economic and fiscal strategy is beginning to pay off and there are signs that the economy is now gaining strength. A rebound is particularly evident in the housing market and business investment intentions for 1996 have been revised up significantly.

This document is designed to facilitate the dialogue among Canadians on how best to continue the progress in restoring the federal government's finances – a key condition for sustained economic growth and job creation.

The public consultations that took place leading up to the last three budgets were instrumental in determining the strategy and measures that formed those budgets. Due to these measures, the necessary actions are now being implemented to achieve the announced deficit targets.

The House of Commons Standing Committee on Finance will be asked to consult with Canadians and advise on:

- First, are the updated economic assumptions for 1996 and 1997 prudent – particularly with respect to interest rates and nominal income – and what should the economic assumptions for these two variables be for 1998?

- And second, although focus has primarily been placed in recent years on the Public Accounts deficit, there are other complementary measures of the federal government's fiscal position – net public debt, interest-bearing debt, financial requirements, National Accounts deficit. The Auditor General, in his 1995 report to the House of Commons, *Deficits and Debt: Understanding the Choices*, recommended that more attention be paid to the debt-to-GDP ratio. How should these different fiscal measures be used by the government to improve understanding of the government's overall fiscal health and how should they be used in setting the future course of fiscal policy?

Annex 1

Fiscal Outlook: Sensitivity to Economic Assumptions

Sensitivity to changes in economic assumptions

Estimates of the main fiscal aggregates are sensitive to changes in economic assumptions – particularly to the level of nominal income and interest rates. The following sensitivity estimates capture the direct fiscal impacts of changes, one economic variable at a time. These are partial calculations. For example, in the nominal income sensitivity estimate, there is no feed-through of the change in nominal income to other variables, such as interest rates and unemployment.

Sensitivity to changes in nominal income

A one-per-cent increase in the level of nominal GDP leads to higher tax bases and thus higher revenues. The ultimate deficit impact would depend on the source of the increase in nominal incomes. The most favourable impact on the fiscal situation would occur if all of the increase in nominal GDP resulted from increased productivity. Inflation and interest rates would not rise and indeed could decline. Revenues would be higher and borrowing costs lower.

If, however, the improvement in nominal GDP was solely due to inflation, then some of the positive impact of government revenues would be offset by higher spending on those programs indexed to inflation.

Higher nominal GDP, caused either through higher inflation or stronger demand in the economy, would likely raise interest rates, thereby increasing public debt charges.

Assuming the increase in nominal incomes comes solely from an increase in productivity, the deficit would be lowered by $1.3 billion in the first year, rising to $1.7 billion after four years, as savings from lower debt charges begin to accumulate (Annex Table A1.1).

Table A1.1
Fiscal sensitivity analysis: 1-per-cent increase in nominal income

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue increases	1.2	1.3	1.4	1.6
Expenditure reductions	0.1	0.2	0.1	0.1
Deficit reduction	1.3	1.5	1.5	1.7

Sensitivity to changes in interest rates

In contrast to the uncertainties of the sensitivity of the deficit to changes in nominal GDP, the direct impact of interest rate changes on public debt charges can be calculated with considerable precision.

A sustained 100-basis-point decline in all interest rates would cause the deficit to decline by $1.3 billion in the first year (Annex Table A1.2). As longer-term debt matures and is refinanced at the lower interest rates, the favourable impact on the deficit increases, such that by year four, the deficit is about $3.0 billion lower.

Table A1.2
Fiscal sensitivity analysis: 100-basis-point decline in all interest rates

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue decrease	0.3	0.4	0.4	0.4
Expenditure reductions	1.7	2.6	3.0	3.4
Deficit reduction	1.3	2.2	2.6	3.0

Annex 2

The Budgetary Deficit, Financial Requirements, and the National Accounts Deficit

There are three basic measures of the federal government's fiscal position in Canada – the budgetary deficit/surplus, financial requirements/sources, and National Accounts deficit/surplus. Corresponding to each of these measures are indicators of the net debt position of the federal government.

Differences in the measures arise because the accounting frameworks are designed for different purposes.

The fundamental purpose of the first two measures (budgetary deficits and financial requirements – Public Accounts measures) is to provide information to Parliament on the government's financial activities as required under the *Financial Administration Act*. The purpose of the Public Accounts is to permit parliamentary control of public funds into and out of the Consolidated Revenue Fund. The results are based on generally accepted accounting principles and are audited by the Auditor General of Canada.

Financial requirements/sources primarily measure the amount by which net cash going out from the government exceeds cash coming in – the amount of money that the government has to borrow in private credit markets. The budgetary deficit/surplus includes all transactions with outside parties which enter into the calculation of the deficit or surplus of the government. The budgetary deficit/surplus is a more comprehensive measure as it includes liabilities incurred during the year for which no cash payment has been made and only those revenues and program spending over which Parliament has control.

■ The main difference between the budgetary deficit and financial requirements relates to the treatment of the federal government's employee pension accounts. The budgetary deficit only includes the government's annual pension-related costs (the contribution as an employer plus interest on its borrowings from the pension accounts) while financial requirements include the net difference between premiums and benefits paid out.

■ In addition, the budgetary deficit includes all of the federal government's obligations made during the course of the year while financial requirements only include the actual cash outlay related to these obligations.

Most industrialized countries present their budgets on a basis that is more comparable to financial requirements than to the budgetary deficit.

The primary objective of the National Accounts is to measure economic production and income. Thus, the government sector is treated on the same basis as other sectors of the economy. The primary objective of measuring economic activity means that certain transactions are recorded on an accrual basis in order to measure when revenues and expenditures are incurred. The National Accounts treats the transactions of federal government employee pension accounts similar to the financial requirements. The National Accounts estimates are produced by Statistics Canada.

■ The National Accounts deficits/surpluses are largely used for international fiscal comparisons by the Organization for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF).

■ The National Accounts also provide a consistent framework for aggregation and comparison of the fiscal positions of the various levels of government in Canada.

Each measure provides important complementary perspectives on the government's fiscal position.

■ Although the levels are different, the trends are broadly similar (Table A2.1).

■ Financial requirements and the National Accounts deficit are broadly similar in level and both are considerably lower than the Public Accounts deficit, reflecting the inclusion of the net amount of the federal government's employees' pension funds.

Table A2.1

Alternative measures of the federal balance 1980-81 to 1995-96 (fiscal years)

	Budgetary surplus or deficit (-)		Financial requirements (excluding foreign exchange transactions)		National accounts surplus or deficit (-)	
Year	Millions of dollars	Percentage of GDP	Millions of dollars	Percentage of GDP	Millions of dollars	Percentage of GDP
1980-81	-14,556	-4.7	-9,917	-3.2	-9,604	-3.1
1981-82	-15,674	-4.4	-9,264	-2.6	-9,062	-2.5
1982-83	-29,049	-7.8	-23,819	-6.4	-23,486	-6.3
1983-84	-32,877	-8.1	-25,219	-6.2	-25,957	-6.4
1984-85	-38,437	-8.6	-29,824	-6.7	-32,584	-7.3
1985-86	-34,595	-7.2	-30,510	-6.4	-27,872	-5.8
1986-87	-30,742	-6.1	-22,918	-4.5	-24,089	-4.8
1987-88	-27,794	-5.0	-18,849	-3.4	-19,510	-3.5
1988-89	-28,773	-4.7	-22,424	-3.7	-20,592	-3.4
1989-90	-28,930	-4.4	-20,530	-3.2	-22,253	-3.4
1990-91	-32,000	-4.8	-24,538	-3.7	-27,416	-4.1
1991-92	-34,357	-5.1	-31,800	-4.7	-28,702	-4.2
1992-93	-41,021	-5.9	-34,497	-5.0	-31,060	-4.5
1993-94	-42,012	-5.9	-29,850	-4.2	-35,077	-4.9
1994-95	-37,462	-5.0	-25,842	-3.5	-28,560	-3.8
1995-96	-28,617	-3.7	-17,183	-2.2	-25,747	-3.3

Source: Public Accounts of Canada.

As the deficits/surpluses derived from these three measures are different, so are the measures of debt. The accumulation of annual budgetary deficits and surpluses since Confederation is the net public debt. This represents the total liabilities of the government less its financial assets. For financial requirements, the relevant measure is unmatured debt (market debt). Interest-bearing debt is the summation of unmatured debt outstanding from private credit markets as well as the borrowings from public sector pension accounts and other internal funds held for third parties. It is greater than net debt as the latter includes financial assets. The National Accounts debt represents the net financial liabilities of the federal government (Table A2.2).

Table A2.2

Alternative measures of the federal debt 1980-81 to 1995-96 (fiscal years)

	Net debt		Interest-bearing debt		Unmatured debt		National accounts debt[1]	
Year	Millions of dollars	Percentage of GDP	Millions of dollars	Percentage of GDP	Millions of dollars	Percentage of GDP	Millions of dollars	Percentage of GDP
1980-81	91,948	29.7	112,418	36.3	83,138	26.8	49,609	16.0
1981-82	107,622	30.2	126,684	35.6	93,167	26.2	57,817	16.2
1982-83	136,671	36.5	154,221	41.2	116,562	31.1	79,547	21.2
1983-84	169,549	41.8	184,849	45.6	142,901	35.2	105,765	26.1
1984-85	207,986	46.8	219,458	49.3	172,719	38.8	136,620	30.7
1985-86	242,581	50.8	253,381	53.0	201,229	42.1	169,619	35.5
1986-87	273,323	54.1	286,034	56.6	228,611	45.2	195,919	38.7
1987-88	301,117	54.6	313,948	56.9	250,809	45.5	215,613	39.1
1988-89	329,890	54.4	345,057	56.9	276,301	45.6	236,708	39.1
1989-90	358,820	55.1	370,104	56.9	294,562	45.3	262,021	40.3
1990-91	390,820	58.4	406,475	60.7	323,903	48.4	287,618	43.0
1991-92	425,177	62.9	440,181	65.1	351,885	52.0	309,189	45.7
1992-93	466,198	67.6	477,034	69.1	382,741	55.5	340,699	49.4
1993-94	508,210	71.3	514,510	72.2	413,975	58.1	366,494	51.4
1994-95	545,672	73.3	550,192	73.6	440,998	59.0	401,815	53.8
1995-96	574,289	74.0	586,387	75.5	469,547	60.5	428,976	55.3

[1] National Accounts debt figures represent net financial liabilities on a calendar year basis.

Source: Statistical Canada, *National Balance Sheet Accounts* (Cat. 13-214, category 2000).

Annex 3

Fiscal Progress in an International Context

Introduction and overview

This annex provides an assessment of the public sector financial situation in Canada in contrast with that in other G-7 countries.

For fiscal comparisons between countries, Public Accounts figures may not be consistent due to differences in accounting practices and possible differences in the shared fiscal responsibilities among levels of government within individual countries.

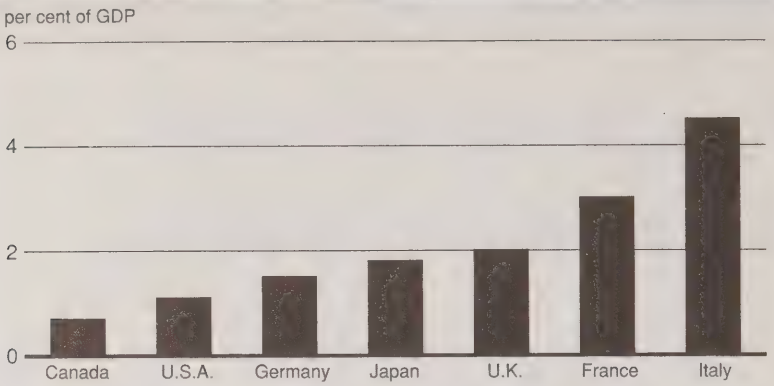
To overcome these obstacles, the majority of the following charts present Canada and the other G-7 countries on a more consistent basis using National Accounts figures at the total government level.

Canadian governments have undertaken consistent fiscal consolidation measures, making significant progess in deficit reduction, predominantly through program spending reduction. By 1997, the total government sector will be on a secure path to lower levels of public debt relative to GDP and an increasingly secure fiscal environment.

Lowest financial requirements among G-7

Financial requirements measure the amount by wich cash going out from the government exceeds cash coming in and is a good indication of net direct government borrowing on credit markets. In 1997, Canada will have the lowest ratio of financial requirements to GDP among all central governments in the G-7 countries (Chart A3.1).

Chart A3.1 Projected 1997 central government financial requirements



Source: National budget plans.

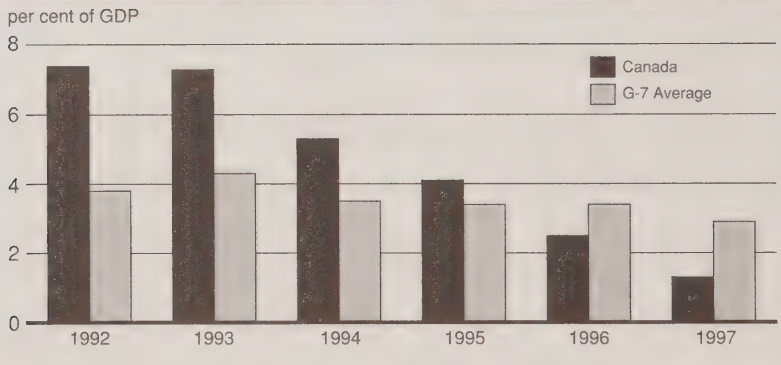
Total government deficit lowest among G-7

The total government deficit on a National Accounts basis records the difference between total receipts and total outlays. In 1992, the total government deficit in Canada, at 7.4 per cent of GDP, was nearly double the G-7 average.

However, as a result of deficit reduction efforts in recent years, governments in Canada have closed the gap with respect to G-7 countries. The total government deficit as a share of GDP in Canada will fall *below* the G-7 average (Chart A3.2) in 1996, with the gap in favour of Canada widening further in 1997.

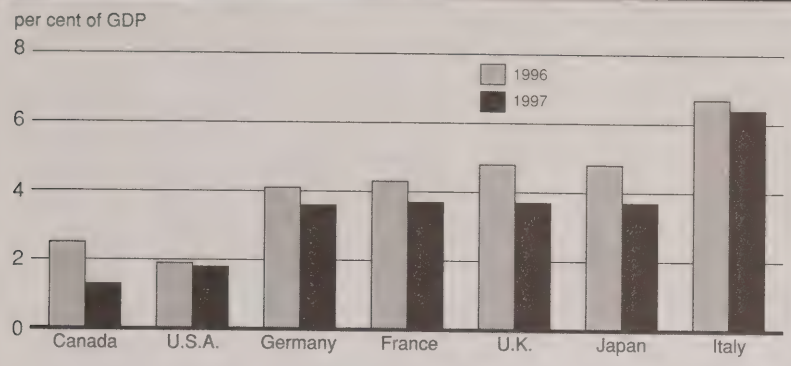
By 1997, Canada's total government deficit as a share of GDP will be the lowest among the G-7 countries (Chart A3.3).

Chart A3.2 Total government deficit (National Accounts basis)



Source: Canada, Department of Finance; G-7 Average, OECD Economic Outlook, 1996.

Chart A3.3 Total government deficit in G-7 countries (National Accounts basis)



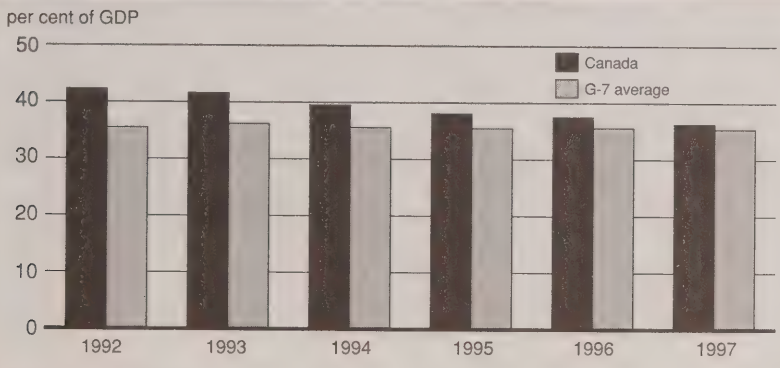
Sources: Canada, Department of Finance; G-7, *OECD Economic Outlook*, 1996.

Program spending reduced sharply

The bulk of fiscal consolidation in Canada has been achieved through program spending restraint. Canada's program spending as a share of GDP has been steadily declining since 1992. As a result, while Canadian program spending as a percentage of GDP was significantly above the average for the G-7 countries in 1992, by 1997, it will be only marginally higher (Chart A3.4).

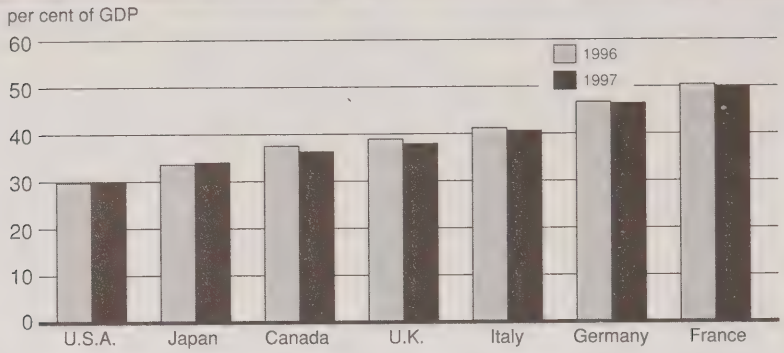
The ratio of program spending to GDP in Canada will be the third lowest in 1996, behind the United States and Japan (Chart A3.5). Total government program spending in Canada will continue to fall relative to GDP in 1997.

Chart A3.4 Total government program spending (National Accounts basis)



Source: Canada, Department of Finance; G-7 Average, *OECD Economic Outlook*, 1996.

Chart A3.5 Total government program spending in G-7 countries (National Accounts basis)



Source: Canada, Department of Finance; G-7 Average, *OECD Economic Outlook*, 1996.

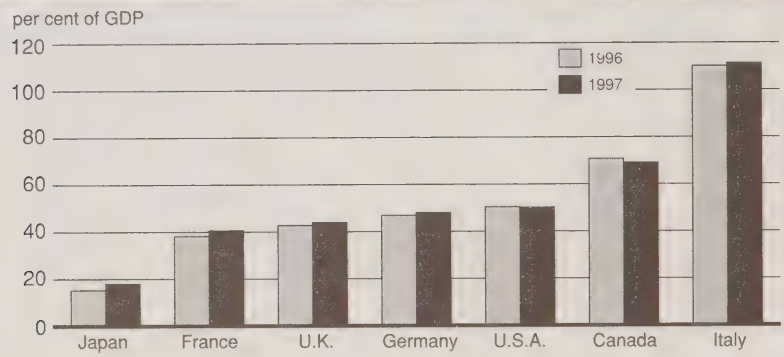
Net debt-to-GDP ratio declining more rapidly

Successful deficit reduction in Canada has led to a declining net debt-to-GDP ratio.

In 1997, the Canadian net debt-to-GDP ratio will decline by almost two percentage points, while increasing in a majority of other G-7 countries (Chart A3.6).

Canada's success in reducing the net debt-to-GDP ratio will ultimately bring about a sustainable level of public debt and an increasingly secure fiscal environment.

Chart A3.6 Total government net debt in G-7 countries (National Accounts basis)



Source: Canada, Department of Finance; G-7 Average, *OECD Economic Outlook*, 1996.

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1

Introduction and Overview

The government's overarching economic goal is to foster strong economic growth and job creation. The first step in achieving this goal is to ensure that the government's own fiscal performance complements Canada's economic strengths. Restoring fiscal health to the nation's finances allows interest rates to come down and stay down to stimulate the economy. This is the path the government has followed since 1993-94; it is the path it will follow in the future.

The strategy is working:

- the deficit is down to its lowest level in 20 years and will continue to fall;
- Canadian interest rates have come down to their lowest levels in decades;
- the economy is now growing at a strong pace; and
- job creation is strong.

Today, the challenge for the federal government is to build on this progress by creating opportunity and security for all Canadians.

Economic and Fiscal Context Extremely Positive

The government's action plan of the past four years has focused on restoring fiscal health and modernizing the role of government. That plan recognized that fiscal health and economic growth go hand in hand – achieving

strong and sustained economic growth was not possible without restoring Canada's fiscal health and, without a strong economy, there could be no sustained improvement in the nation's fiscal situation.

This strategy is paying off. The economy is now growing very strongly, and at no time in the past 25 years has the economic environment in Canada been more positive. The government's action plan to restore sound finances, combined with low and stable inflation, has contributed to a significant decline in interest rates. This has fuelled the recent strong growth that is creating jobs, and reflects a new optimism on the part of consumers and businesses about the future. Altogether, these positive developments provide a sound basis for continued strong growth.

The deficit for 1996-97 was $8.9 billion – down $19.7 billion from 1995-96.

Just as the fiscal turnaround has directly contributed to the improvement in Canada's economic environment, stronger growth and job creation have reinforced the impact of the government's direct actions to reduce the deficit. The deficit for 1996-97 was $8.9 billion, down $19.7 billion from the 1995-96 outcome and the smallest deficit since 1976-77. This marks the third year in a row that the government's deficit targets have been surpassed. The deficit is continuing to decline and the government is committed to achieving a balanced budget no later than 1998-99.

The budget will be balanced by no later than 1998-99.

Remaining Fiscal Challenge

As a result of the significant decline in the federal deficit in 1996-97, Canada's debt-to-GDP ratio fell to 73.1 per cent – the first meaningful decline in 25 years. With a balanced budget to be achieved no later than 1998-99, this ratio will continue to decline in the coming years. But the burden of public debt is still too high by both historical and international standards.

The debt-to-GDP ratio needs to be reduced.

Reducing the debt-to-GDP ratio is key to ensuring that the long-run benefits of improved health in the nation's finances are realized and maintained. In the short-run, this may require a reduction in the absolute level of the debt. Nevertheless, the debt-to-GDP ratio is the most appropriate indicator of the nation's ability to carry debt. Just as households and businesses with higher incomes can support higher debt, the larger a country's gross domestic product (GDP), the larger the *absolute level* of debt it can support. But there are clear limits to this carrying capacity.

In Canada's case, there are a number of factors that underscore the importance of achieving further significant reductions in the debt-to-GDP ratio.

- Currently, public debt charges absorb about 32 cents of every revenue dollar collected. Reducing the debt-to-GDP ratio will mean that some of the revenues now being absorbed by debt charges can be used for the nation's key priorities – for example, health care, education, pensions, lower taxes, etc.

- Reducing the debt-to-GDP ratio will reduce the vulnerability of Canada's fiscal situation to economic shocks, particularly interest rate increases.

- Reducing the debt-to-GDP ratio will improve economic efficiency and growth by providing an environment that is more conducive to entrepreneurship and investment. This occurs because a lower debt-to-GDP ratio brings with it the potential for permanently lower taxes and interest rates.

- Finally, it is also a matter of fairness to today's youth and future generations. Younger Canadians have received relatively less benefit from the build-up in Canada's debt. The debt-to-GDP ratio should be reduced now, while the generations that benefited most from its run-up are still in the labour force.

Prospering in a Knowledge-Based Economy

Fundamental changes are taking place in Canada's economy ...

While the economic indicators are much healthier today than at any point in the past 25 years, other fundamental changes are taking place in Canada's economy that require ongoing adjustment. The development and use of information and knowledge are fast becoming the main engines of long-term growth in all industries. This change is raising educational and skill requirements throughout the economy and accelerating the integration of the world's economies.

Canadians believe that they can prosper in the economy of the 21st century. But they are also concerned about how these changes will affect them, their families and those who are unable to take advantage of the opportunities economic change will bring. They are concerned too about the future of health, education and social programs that serve and

unite Canadians. That is why Canadians want a government that responds to economic change by providing leadership. The federal government is taking an active role in creating opportunities and building security for Canadians by:

- working with Canadians to build a strong, modern economy that will generate more and better jobs and raise living standards; and
- securing Canada's health, education and social programs so that the benefits of economic growth can be shared by all.

This document sets out the government's key roles and responsibilities in encouraging economic growth and translating it into a better quality of life for all Canadians.

Outline of *The Economic and Fiscal Update*

The rest of this document is organized as follows:

- **Chapter 2** reviews recent economic developments and their implications for the assumptions underlying the federal government's fiscal planning. It highlights the fact that the economy has strengthened considerably over the last year, translating into strong job gains.
- **Chapter 3** explains the final deficit outcome for 1996-97, states the government's fiscal guidelines for future years and discusses the challenge of putting the debt-to-GDP ratio on a permanent downward track to ensure sustained economic growth and more jobs for Canadians.
- **Chapter 4** describes the emerging global economy based on knowledge and skills. It also details the federal government's role in providing active leadership in several areas key to Canada's prosperity in this new environment.
- **Chapter 5** presents the conclusions and main issues, including a number of specific questions on which the House of Commons Standing Committee on Finance will be asked to provide advice.

In addition, there are two annexes. Annex 1 reviews the progress made at the provincial level. Annex 2 describes the fiscal sensitivity of changes in economic growth and interest rates.

2

A Growing Economy and Stronger Job Creation: The Payoff from Sound Policies[1]

Highlights

- Economic conditions have improved considerably over the past year.
- In the first eight months of the year, 263,000 jobs were created, all in the private sector and most of them full-time positions.
- The encouraging outlook reflects steep declines in interest rates resulting from restored fiscal health and continued low inflation.
- One-year mortgage rates have fallen over 400 basis points since January 1995, providing substantial interest rate relief for homeowners. Five-year mortgage rates are presently at their lowest levels in a generation.
- Private sector forecasters expect growth of about 3.7 per cent in both 1997 and 1998 – the strongest back-to-back growth in almost 10 years.

Introduction

Economic developments since the February 1997 budget have been very encouraging. Growth has strengthened, leading to strong employment gains and lower unemployment. The near-term outlook is also promising, as private sector economists forecast strong growth of 3.7 per cent in both 1997 and 1998. This outcome would be the best two-year performance of the economy in almost 10 years. Major international organizations, such as the International Monetary Fund (IMF) and the Organization for

[1] All statistical references are as of Thursday, October 2.

Economic Co-operation and Development (OECD), share this very favourable assessment of the Canadian economy's growth prospects.

The improved economic outlook results from a number of factors. Most important are the determined efforts by the federal and provincial governments to address the fiscal problems that seemed so intractable only a few years ago, and which threatened the country's long-term prosperity. Improved public finances have allowed interest rates to fall to historic lows, fuelling the economic growth that is creating jobs. Confidence on the part of households and businesses has improved enormously – *Canadians are once again starting to have confidence in their economic future.*

This chapter briefly reviews recent economic developments and discusses the factors accounting for the renewal of consumer and business confidence underlying the improved outlook, in particular the key role of improved financial management. It outlines the results of the latest survey of private sector forecasters, which will provide the basis for the near-term economic assumptions to be used for fiscal planning in the 1998 budget.

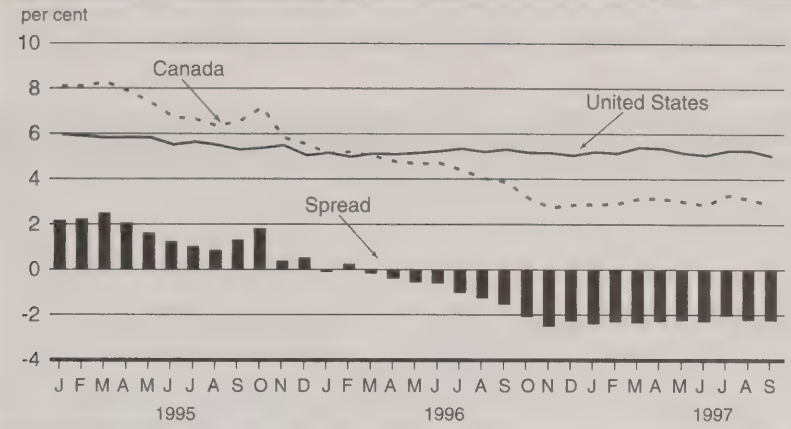
Recent Economic Developments

... fiscal progress has allowed monetary conditions to become and remain highly supportive of growth.

In 1993, the government recognized that the restoration of sound public finances would have to be a central element of its strategy to restore growth and create jobs for Canadians. Since that time, the progress made in terms of fiscal consolidation has allowed monetary conditions to become and remain highly supportive of growth. Indeed, the results have been better than anyone expected. As noted in the February budget, interest rates earlier this year were well *below* the average forecast among private sector forecasters one year earlier. And interest rates have remained at very low levels.

These low interest rates reflect, in part, reduced risk premiums attached to Canadian assets. This effect is most noticeable in the substantial negative spreads between comparable Canadian and U.S. interest rates. Negative spreads on short-term interest rates have prevailed for the past 19 months – the longest such period since the early 1970s (Chart 2.1).

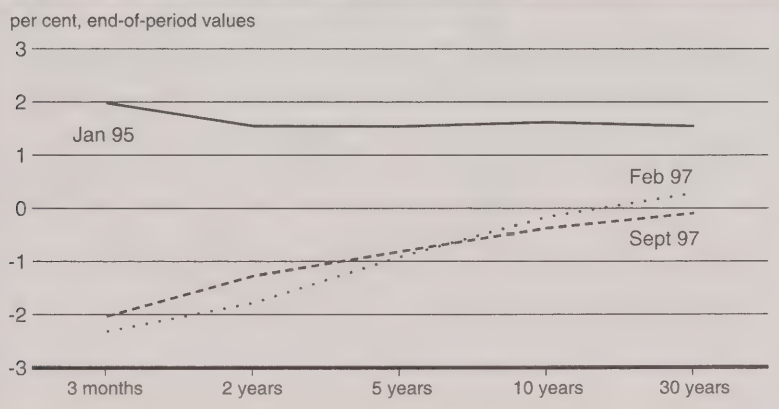
Chart 2.1 Canadian and U.S. three-month Treasury bill rates



Long-term Canadian interest rates have also fallen below U.S. rates. The rate on 10-year bonds has generally been below that in the U.S. since last fall and rates on 30-year bonds are now slightly below those in the U.S. (Chart 2.2).

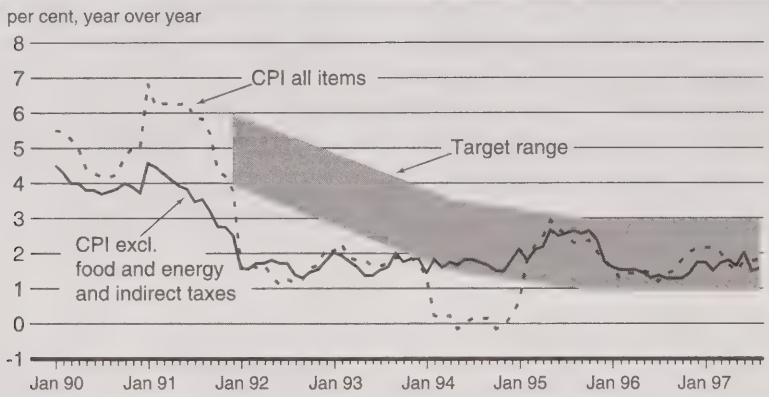
The current favourable interest rate environment would not have been possible without the substantial improvement in public finances. At the same time, Canada's commitment to low inflation – clearly demonstrated by the 1- to 3-per-cent inflation range established jointly by the government and the Bank of Canada – has also been important in supporting this improved financial environment. The range assures all investors that the government and the Bank of Canada are committed to containing cost and price pressures as the expansion continues. Consumer price inflation,

Chart 2.2 Canada-U.S. yield curve spreads



excluding the effects of changes in food and energy prices, has remained at or below the mid-point of the current range for the past 21 consecutive months (Chart 2.3).

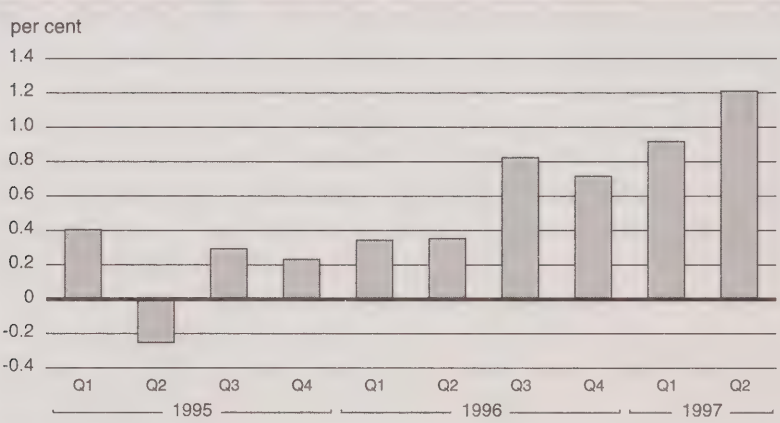
Chart 2.3 CPI inflation



The Payoff: Stronger Growth and Job Creation

There is little question that economic prospects have improved considerably over the past year. The economy has grown at an average annual rate of 3.7 per cent over the four quarters to mid-1997. And the pace of economic activity has been accelerating over this period, as real gross domestic product (GDP) was up 1.2 per cent (an annual growth rate of 4.9 per cent) in the second quarter (Chart 2.4).

Chart 2.4 Real GDP growth



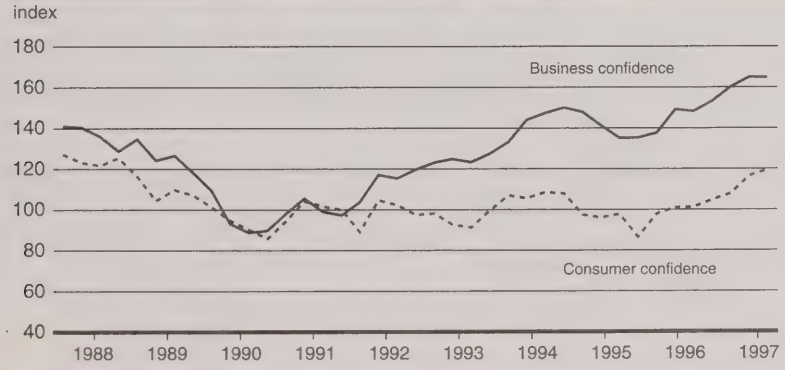
The stronger growth that has been recorded over the past four quarters reflects the effect of significant interest rate declines from the peaks reached in 1995. Looking ahead, the further interest rate declines in the fall of 1996 provide a sound base for continuing growth through 1998. The declines in long-term interest rates are particularly significant, both because they show that financial markets expect short-term interest rates to remain at low levels for some time, and because many firms finance their capital investment at long-term rates.

... the further interest rate declines of last fall provide a sound base for continuing growth through 1998.

Low interest rates and the successes achieved by the federal and provincial governments toward putting their fiscal houses in order have translated concretely into improved household and business confidence. Consumer confidence, as measured by the Conference Board of Canada, has improved markedly in recent months, and stands at its highest level in eight-and-a-half years, while business confidence remained at the highest level on record (Chart 2.5). It should not be surprising in this environment that sales of durable consumer goods have been very strong in recent months. There are also clear signs of strength in the housing sector, with housing starts in the first eight months of 1997 up 24 per cent over the same period last year. And real business investment in machinery and equipment surged in the second half of 1996 and the first half of 1997, rising by 25 per cent.

There is also evidence that the strong business investment performance witnessed in recent months will continue and become more broadly based. The July Survey of Public and Private Investment Intentions indicates that firms expect to increase their investment by some 14 per cent in 1997, a

Chart 2.5 Consumer and business confidence



Source: Conference Board of Canada.

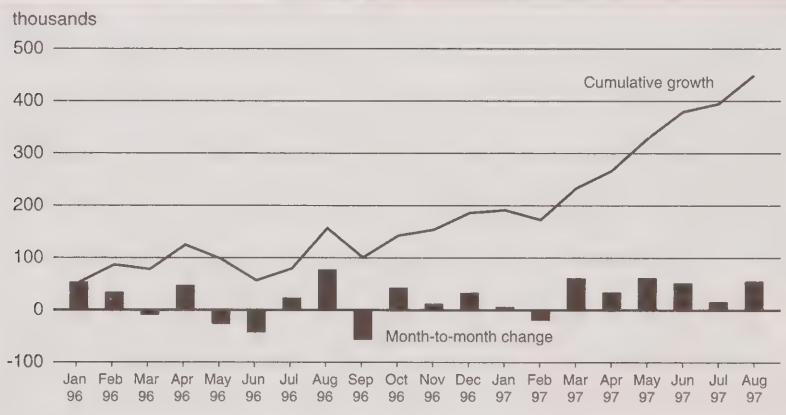
marked upward revision from their intentions only six months earlier. Moreover, the survey suggests that investment spending will broaden from machinery and equipment, much of which is imported, to non-residential construction, which has much more of a direct impact on domestic activity and job creation. Evidence of this trend emerged in the second quarter.

Another positive development is the trend improvement in the current account which, in late 1995, posted its first surplus in 11 years. This decline in Canada's reliance on foreign savings resulted from sharply reduced borrowing by federal and provincial governments. A corresponding decline has emerged since 1993 in Canada's net foreign debt as a share of GDP, from 45.4 per cent in 1993 to 41.7 per cent in 1996. Although the current account has moved back into a modest deficit position in the last several quarters, these recent deficits are well below those of the early 1990s. Moreover, one of the main factors behind the re-emergence of small current account deficits is a surge in investment spending that is boosting the Canadian economy's long-run growth and export potential.

Strong growth is creating employment opportunities for Canadians across the country.

Strong growth is creating employment opportunities for Canadians across the country. This has always been the ultimate goal of the government's economic strategy, which is now coming to fruition. Employment growth began to strengthen in the second half of 1996, when 130,000 jobs were created. Job creation has continued to strengthen since the end of last year, with employment having increased for six consecutive months through August (Chart 2.6). Indeed, during the first eight months of this year, 263,000 new jobs were created, all of them in the private sector and

Chart 2.6 Employment growth



most of them full-time positions. The economy is well placed to exceed the threshold of the 300,000 new jobs figure that many economists had forecast for this year at the time of the budget. Also encouraging is the clear evidence that Canada's youth are sharing in this strong job creation: 52,000 of the 121,000 jobs created over the May to August period have been filled by young people. Most important of all, the strong employment growth witnessed in recent months has the potential to generate a "virtuous circle" in which higher household incomes and improved confidence lead to stronger consumer spending, higher growth and even stronger job creation.

The Near-Term Outlook

These positive domestic developments have led private sector forecasters to expect strong growth in both 1997 and 1998. While much of this reflects the payoff from good Canadian economic policy, it also reflects an international environment that is supportive of growth in Canada.

The External Environment

The economic environments in both the United States and the major overseas economies are expected to remain conducive to growth and job creation in Canada, although there are risks that need to be taken into consideration in our fiscal planning.

The United States

Developments in the U.S. economy demonstrate clearly that strong and steady growth with low unemployment can be achieved together with stable inflation. At the same time, a major policy debate is underway in the U.S. with respect to the near-term prospects for the economy. Over the past year, the U.S. economy has expanded at a robust pace that some analysts believe may have pushed the economy beyond its maximum sustainable output. Other analysts, in contrast, believe that potential output growth has in fact increased in the U.S. economy as a result of sustained capital expansion, particularly in information technologies. They argue that the application of new technologies may have unleashed productivity improvements that have raised the productive capacity of the economy, or

will soon raise it as firms become more adept with that technology. They also contend that the development *and* adoption of information technology in recent years has made physical capital more flexible than it once was, enabling firms to adapt more quickly than in the past to shifting demands.

These effects are believed to be assuming greater importance. But the available evidence on their impact on the overall economy is inconclusive. And, while the nature of capital may be changing, the economy can still face capacity constraints in labour markets that could put upward pressure on wages and, ultimately, prices.

The most likely development in the view of most private sector economists is for the U.S. economy to grow at a more moderate pace in the quarters ahead (Table 2.1). Indeed, growth slowed somewhat in the second quarter (albeit to a still-strong 3.3 per cent). The appreciation of the U.S. dollar over the last several quarters is expected to help ensure that growth moderates further and, thus, that inflation pressures stay contained. There is, nonetheless, an expectation that short-term interest rates could rise in the coming months.

Table 2.1
U.S. economic outlook – private sector consensus

	1996	1997	1998
		(per cent)	
Real GDP	2.8	3.6	2.4
CPI	3.0	2.5	2.7
3-month Treasury bill rate	5.1	5.2	5.4
10-year government bond rate	6.4	6.5	6.4

Source: *Blue-Chip Economic Indicators*, September 10, 1997. This is a survey of approximately 50 private sector forecasters of the U.S. economy.

Major Overseas Economies

Private sector forecasters expect that growth in the major overseas economies will strengthen modestly in 1997 and into 1998. One of the most positive factors shaping the economic situation in these countries is the virtual absence of inflationary pressures. This provides monetary authorities considerable scope to maintain interest rates at their present accommodative levels, a stance that supports both growth and deficit reduction.

But there are risks to this outlook. Concerns have emerged that the moderate economic recovery underway in Japan may be curtailed if domestic demand fails to strengthen. In Europe, unemployment remains high and there is considerable uncertainty about prospects for domestic demand and sustained growth.

Private Sector Assessment of the Economic Outlook for Canada

Canadian forecasters have become more optimistic since the 1997 budget.

Canadian private sector forecasters have become more optimistic since the 1997 budget, significantly revising upwards their forecasts for growth in both 1997 and 1998. The consensus among private sector forecasters surveyed by the Department of Finance is that the Canadian economy will grow by 3.7 per cent in both 1997 and 1998. Prior to the 1997 budget, these forecasters expected 3.3 per cent growth for 1997 and only 2.9 per cent growth for 1998 (Table 2.2).

Other aspects of the private sector consensus have changed little from the very positive outlook prevailing at the beginning of the year. Short-term interest rates are expected to remain very low by historical standards, although private sector forecasters now expect rates to rise by somewhat more in 1998, reflecting in part, expectations of higher interest rates in the U.S. The higher interest rates expected by private sector forecasters in 1998 also reflect their view that interest rates will rise as the economy nears its productive potential. Forecasters also expect strong growth will fuel job creation sufficient to reduce further the unemployment rate over the course of 1998.

Strong growth will fuel job creation sufficient to reduce Canada's high unemployment rate.

Major international organizations share this very favourable assessment of Canada's growth prospects. The most recent forecasts by the IMF and the OECD project that Canada's economy will achieve the strongest economic growth in the Group of Seven (G-7) countries on average over the 1997 to 1998 period.

Table 2.2
Evolution of private sector forecast survey results

	1996*	1997	1998
Real GDP growth (%)			
February 1997	1.5	3.3	2.9
September 1997	1.5	3.7	3.7
Nominal GDP growth (%)			
February 1997	2.8	4.9	4.7
September 1997	2.8	4.7	5.2
Nominal GDP ($ billion)			
February 1997	798	837	876
September 1997	798	835	879
CPI inflation (%)			
February 1997	1.6	1.6	1.8
September 1997	1.6	1.8	2.0
Unemployment rate (%)			
February 1997	9.7	9.3	8.8
September 1997	9.7	9.2	8.6
Employment growth (%)			
February 1997	1.3	2.0	2.0
September 1997	1.3	2.0	2.4
3-month Treasury bill rate (%)			
February 1997	4.2	3.2	3.7
September 1997	4.2	3.2	4.1
10-year govt. bond yield (%)			
February 1997	7.2	6.6	6.6
September 1997	7.2	6.3	6.3

*1996 values are actual data.

Prudent Assumptions for Fiscal Planning

The prudence factors for fiscal planning adopted at the time of the 1997 budget were for short-term interest rates 80 basis points higher than the private sector average in 1997 and 1998, and long-term rates 50 basis points higher than forecast by the private sector.

The choice of these prudence factors reflected two main considerations:

- With the U.S. economy generally considered to be operating at its productive capacity, there was a risk that stronger-than-expected economic growth or signs that upward pressure on inflation was materializing, could lead the U.S. Federal Reserve to raise interest rates by more than expected. This could then spill over into Canada.

■ The smaller prudence factor applied to long-term interest rates reflected the unusually steep slope of the Canadian yield curve. As long-term interest rates were already high compared to short-term rates, the view was that they might not rise commensurately with any future increase in short rates.

An issue to be addressed in the months ahead is what economic assumptions to use for the 1998 budget. These assumptions should reflect the consensus view of private sector forecasters for 1998 and 1999 with appropriate prudence factors applied in light of the perceived risks.

3

Maintaining a Healthy Fiscal Climate: Eliminating the Deficit

Highlights

- Deficit for 1996-97 at $8.9 billion: smallest deficit since 1976-77 and down $19.7 billion from 1995-96.
- Budget to be balanced no later than 1998-99.
- Financial requirements eliminated in 1996-97 – in other countries, including the United States, this would be a balanced budget.
- Net public debt-to-GDP ratio declined to 73.1 per cent in 1996-97 – the first meaningful decline since 1974-75.

Restoring health to the nation's finances has been a key element of the government's strategy to build a stronger economy and create jobs for Canadians. This chapter reviews the progress achieved to date in restoring fiscal health and highlights the challenges that remain.

- It reviews the fiscal progress made since 1993-94 and the major factors contributing to the decline in the deficit over the 1993-94 to 1996-97 period.
- It compares the deficit outcome for 1996-97 to the February 1997 budget estimate.
- It puts Canada's progress in restoring fiscal health in the international context.

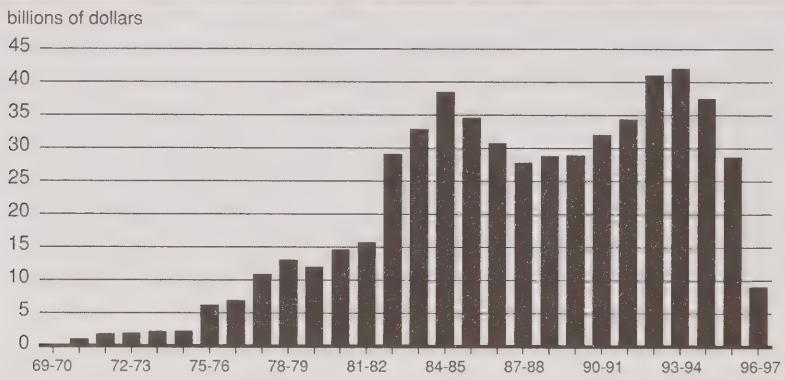
- It sets out the fiscal guidelines that the government will follow in planning future budgets.
- It highlights the need to ensure that the debt-to-GDP ratio is put on a permanent downward track.

Deficit Reduction Since 1993-94

The 1996-97 deficit was $8.9 billion, the smallest deficit recorded since 1976-77.

The 1996-97 deficit was $8.9 billion – the smallest deficit recorded since 1976-77 (Chart 3.1). The deficit was down $19.7 billion from 1995-96 – the largest one-year change in the budget balance. Relative to the size of the economy, the deficit was 1.1 per cent of gross domestic product (GDP) – the lowest level since 1970-71.

Chart 3.1 Budgetary deficit



This decline was attributable to:

- the impact of restraint measures introduced in the 1994 and 1995 budgets, primarily affecting federal program spending;
- the impact of economic growth; and
- the effect of major one-time factors affecting budgetary revenues.

Detailed information on the 1996-97 outcome is provided in the *Annual Financial Report of the Government of Canada – Fiscal Year 1996-97.*

This section provides an overview of the major factors responsible for the unprecedented turnaround in the federal government's fiscal position since 1993-94.

In 1993-94, the deficit was $42.0 billion, or 5.9 per cent of GDP. Since the 1981-1982 recession, the deficit had never been lower than $27.8 billion. Without fiscal action, the debt dynamic in place in the early 1990s meant that the deficit would have remained stuck at a very high level. The continued uncertainty about Canada's financial future that would have ensued would have seriously eroded the economy's growth potential and put in jeopardy the sustainability of Canada's most valued programs.

The government's strategy for achieving its fiscal objectives was based on two-year rolling deficit targets, backed by prudent economic planning assumptions and a sizeable Contingency Reserve. However, deficit reduction was not viewed as an end in itself. The pursuit of deficit reduction at any cost would have had an unduly negative impact on the economy and Canadians. Moreover, economic growth is an essential element of fiscal health. As such, the government has pursued its fiscal strategy in a balanced and sustained manner, recognizing the need to address critical economic and social concerns.

The government has pursued its fiscal strategy in a balanced and sustained manner ...

The deficit targets set for each of the last three years have been bettered.

- The target for 1994-95 was $39.7 billion – the final outcome was $37.5 billion.
- The target for 1995-96 was $32.7 billion – the final outcome was $28.6 billion.
- The target for 1996-97 was $24.3 billion – the final outcome was $8.9 billion.

Since 1993-94, the deficit has been reduced by $33.1 billion, from $42.0 billion to $8.9 billion (Table 3.1). This reduction in the deficit has been due to higher budgetary revenues, primarily from a growing economy, and a reduction in program spending, largely as a result of the restraint measures introduced in the 1994 and 1995 budgets.

Since 1993-94, the deficit has been reduced by $33.1 billion ...

Table 3.1
Evolution of fiscal situation since 1993-94

	1993-94	1994-95	1995-96	1996-97	Change 1993-94 – 1996-97
	(billions of dollars)				
Budgetary revenues					
Personal income tax	51.4	56.3	60.2	63.3	11.9
Corporate income tax	9.4	11.6	16.0	17.0	7.6
EI premiums	18.2	18.9	18.5	19.8	1.6
GST	15.7	16.8	16.4	18.1	2.4
Other excise and sales tax	10.9	10.3	10.2	11.0	0.1
Other revenues	10.4	9.4	9.0	11.7	1.3
Total	116.0	123.3	130.3	140.9	24.9
Program spending					
Major transfers to persons	37.5	35.3	34.5	34.0	-3.5
Major cash transfers: other levels of government					
CHST	18.6	19.2	18.6	14.8	-3.8
Fiscal arrangements	10.5	9.3	9.8	9.8	-0.7
Alternative Payments for Standing Programs	-1.8	-1.8	-1.9	-2.0	-0.3
Total	27.4	26.7	26.5	22.6	-4.8
Reference:					
Total entitlements	37.4	38.2	38.7	35.7	-1.7
CHST entitlements	29.0	29.3	29.6	26.9	-2.1
Direct program spending	55.2	56.7	51.0	48.2	-6.9
Total	120.0	118.7	112.0	104.8	-15.2
Public debt charges	38.0	42.0	46.9	45.0	7.0
Deficit	-42.0	-37.5	-28.6	-8.9	33.1

One-time revenue factors contributed $5.6 billion to deficit cut.

Between 1993-94 and 1996-97, budgetary revenues increased $24.9 billion. Of this increase, $5.6 billion was attributable to one-time factors. Budgetary revenues were depressed in 1993-94 due to transitional costs associated with the introduction of the child tax benefit ($1.2 billion) and the faster processing of personal income tax returns resulting in higher refunds ($1.2 billion). In contrast, one-time factors inflated budgetary revenues by $3.2 billion in 1996-97. This was attributable to the sale of the Air Navigation System ($1.5 billion), the change in remittance procedures for employment insurance (EI) premium revenues ($1 billion) and the reclassification of the air transport tax from program spending to budgetary revenues ($0.7 billion). Prior to April 1996, receipts from the air transport tax were netted against the costs of running airports and, therefore, program

spending. With the sale of the Air Navigation System, these receipts were classified as part of budgetary revenues, effective April 1996. Since this reclassification affects both revenues and program spending, the deficit is unaffected by this change.

About $2.6 billion of the increase in budgetary revenues between 1993-94 and 1996-97 was attributable to the net impact of revenue-raising measures introduced since 1993. These measures were primarily designed to increase the fairness of the tax system and to remove or reduce a number of tax preferences. Over this time period, there were no increases in personal income tax rates.

Table 3.2
Tax measures from 1994 to 1996

	1994-95	1995-96	1996-97
	(billions of dollars)		
Tightening measures			
Eliminate $100,000 capital gains exemption	0.0	0.4	0.3
Extend taxation of employer-provided life insurance benefits	0.1	0.2	0.2
Income test the age credit	0.0	0.2	0.3
Reduce deduction for business meals and entertainment expenses	0.2	0.2	0.3
Eliminate deferral of tax on business income			0.2
Action plan against smuggling	-0.4	0.0	0.2
Other	1.0	0.9	0.6
Total	0.9	1.9	2.1
Rate increases			
Large corporation tax		0.2	0.2
Corporate surtax		0.1	0.1
Temporary capital tax increase for large deposit-taking institutions		0.1	0.1
Gasoline excise tax		0.5	0.5
Other	-0.1	-0.4	-0.4
Subtotal	-0.1	0.5	0.5
Total	0.8	2.4	2.6

The remainder, $16.7 billion, was attributable to economic growth. Between 1993 and 1996, nominal income (the overall tax base for budgetary revenues) increased by about $85 billion. As the economy expands, more people work and pay income taxes; increased consumer spending generates more sales tax revenues; while higher corporate profits result in higher corporate income tax collections.

Program spending has declined by $15.2 billion ...

Since 1993-94, program spending has declined by $15.2 billion, from $120.0 billion to $104.8 billion. This reduction primarily reflects the impact of the restraint measures introduced in the 1994 and 1995 budgets. These included the Program Review measures to restructure direct program spending, reforms to the employment insurance program, and the restructuring of the major transfers to other levels of government.

Among the major components of program spending, major transfers to persons declined by $3.5 billion. Employment insurance benefits were down $5.2 billion, but this was partially offset by an increase in elderly benefits of $1.7 billion. The decline in employment insurance benefits reflected the impact of the reform measures introduced in the 1994 budget and in December 1995, together with improvements in the labour market.

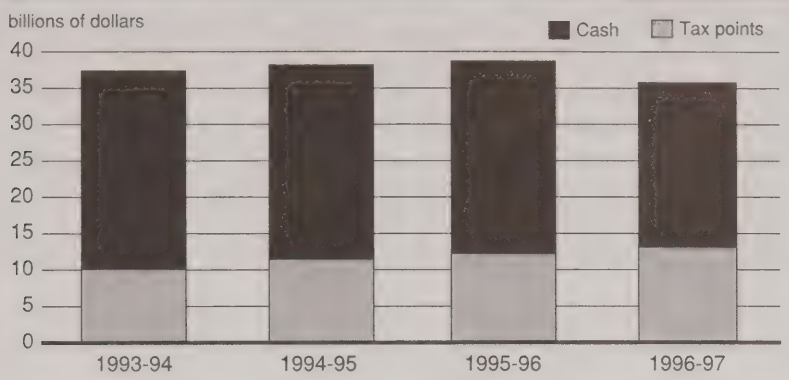
The most appropriate measure of federal transfers to other levels of government is not cash transfers but total entitlements.

Major cash transfers to other levels of government were $4.8 billion lower in 1996-97 than in 1993-94. However, this overstates the net impact on the finances of other levels of government. The most appropriate measure of federal transfers to other levels of governments is not cash transfers but total entitlements. Total entitlements consist not only of cash transfers but also tax point transfers. The tax point transfer represents the value of the "tax room" which the federal government has made available to provincial governments, by reducing federal tax rates so that provinces can increase their tax rates by an equivalent amount, with no impact on the taxpayer.

The value of these tax point transfers fluctuates with changes in the applicable tax bases – personal and corporate income taxes. As these taxes increase due to the growth in the economy, the value of the tax point transfer also increases. Therefore, even with no change in entitlements, cash transfers would decline as the value of the tax point transfers grows.

Total entitlements, including both cash and tax point transfers, declined from $37.4 billion to $35.7 billion, a decrease of $1.7 billion, substantially less than the $4.8 billion decline in cash transfers (Chart 3.2). This difference reflects the growth in the value of tax point transfers and the inclusion of one-time liabilities in 1993-94 under the stabilization program related to the 1990-1991 recession.

Chart 3.2 Transfers to other levels of government



Transfers to other levels of government ...

Cash transfers under the Canada Health and Social Transfer (CHST) were down $3.8 billion. However, only $2.1 billion was due to the reduction in entitlements. The remainder of the decline was attributable to the effect of growing tax bases on the value of the CHST tax point transfer ($1.6 billion) and recoveries related to overpayments made in previous years ($0.1 billion).

Fiscal arrangements, consisting of Equalization, transfers to the territories, stabilization and other smaller statutory transfers, declined $0.7 billion over the period. Liabilities of $1.5 billion were incurred in 1993-94 under the stabilization program, due to the impact of the 1990-1991 recession on provincial revenues. This program provides compensation if economic conditions caused a province's revenues to decline from one year to the next. No such liabilities have been incurred since that time. In addition, as part of Program Review, the Public Utilities Income Tax Transfer was eliminated, resulting in a net saving of $0.2 billion between 1993-94 and 1996-97.

Equalization cash transfers increased by $1 billion between 1993-94 and 1996-97 ...

Equalization cash transfers increased by $1 billion between the 1993-94 to 1996-97 period, while transfers to the territories were up $0.1 billion. The Fiscal Equalization Program provides unconditional transfers that enable less well-off provinces to provide their citizens with reasonably comparable levels of public services at reasonably comparable levels of taxation relative to the national standard.

Table 3.3
Source of change in cash transfers to other levels of government: 1993-94 to 1996-97

	(billions of dollars)
Change in cash transfers	-4.8
Of which:	
CHST entitlements	-2.1
CHST cash due to higher value of tax points	-1.7
Elimination of PUITTA	-0.2
Stabilization liabilities	-1.5
Equalization	1.0
Other	-0.3

Direct program spending declined $6.9 billion.

Direct program spending – that is, total program spending excluding major transfers to persons and to other levels of government – declined $6.9 billion between 1993-94 and 1996-97. This understates the underlying decline ($7.6 billion) as, prior to 1996-97, the air transport tax was netted against program spending.

The decline in direct program spending was attributable to the reform of federal departmental programs.

The decline in direct program spending was attributable to the reform of federal departmental programs. In the February 1994 budget, restraint measures were introduced which significantly reduced defence spending, extended the federal public sector wage freeze and reduced transfer payments. In the February 1995 budget, the government announced the results of Program Review – a comprehensive examination of federal departmental spending. The actions taken resulted in a major decline ($5.7 billion) in this component in 1995-96, one year earlier than the decline in transfers to other levels of government, with a further $2.8 billion decline in 1996-97.

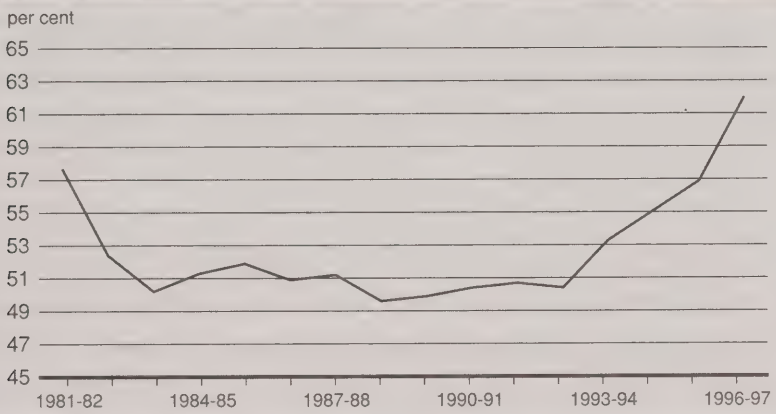
In contrast, public debt charges increased $7 billion over the 1993-94 to 1996-97 period. This increase reflected both the effect of higher average effective interest rates on the stock of the government's debt and increases in that stock due to the deficits that occurred over the entire time period.

Reforms to the structure of the debt stock have reduced the sensitivity of public debt charges to changes in interest rates.

Just as structural changes to program spending have reduced the deficit, reforms to the structure of the debt stock have reduced the sensitivity of public debt charges to changes in interest rates. The reduction in interest rate risk exposure has been a central feature of the government's debt strategy. In 1992-93, half the debt was at fixed rates (one-year maturities and over). By 1995, this proportion had increased to about 55 per cent (Chart 3.3). In that year, the government set a medium-term target of increasing its fixed-rate debt to 65 per cent of the total. With the much lower-than-expected borrowing requirements in 1996-97 and to date in 1997-98, that target has been met. As a result, the government has gained an additional margin of prudence through which it can better manage adverse interest rate developments. For example, a 100-basis-point increase in interest rates would now raise debt by $1 billion in the first year. In the 1995 budget, the first year impact of a 100-basis-point increase was estimated at $1.8 billion.

The government and market participants have undertaken a number of initiatives in recent years to improve the efficiency of the domestic bond markets. As a result, Canada has one of the most efficient bond markets in the world and this has helped reduce the government's debt servicing costs.

Chart 3.3 Fixed-rate share of total debt, 1981-82 to 1996-97



In conclusion, the growth in revenues over the 1993-94 to 1996-97 period was largely attributable to a growing economy. The decline in program spending reflected the combined impacts of the restraint measures and a growing economy.

Deficit Significantly Below Target

The original deficit target for 1996-97, as set out in the March 1996 budget, was 3 per cent of GDP, or $24.3 billion.

In the February 1997 budget, the government indicated that the deficit outcome for 1996-97 would be no higher than $19 billion. This downward revision of $5.3 billion, primarily reflected the impact of the one-time measures (sale of the Air Navigation System and the acceleration of EI premium revenues) and the fact that the Contingency Reserve of $2.5 billion, included in the March 1996 budget deficit target of $24.3 billion, was not needed. The government has committed not to use the Contingency Reserve to finance new policy initiatives; if it is not needed to offset the impact of adverse economic developments, it goes to reduce the deficit.

The final deficit of $8.9 billion was $10.1 billion below the February 1997 budget estimate of $19 billion (Table 3.4). Of this difference:

- budgetary revenues were $5.4 billion higher;
- program spending was $4.2 billion lower; and
- public debt charges were $0.5 billion lower.

All components of budgetary revenues were higher with the exception of personal income tax collections. Corporate and other income tax collections, primarily non-resident withholding taxes, were $1.9 billion higher than estimated in the 1997 budget. About 30 per cent of corporate income tax collections for the year as a whole are received in February and March, reflecting the settlement period for most large corporations. This makes estimating the results for the year as a whole extremely difficult. As corporate profits were relatively unchanged in 1996 from 1995, relatively weak settlement period collections were expected. However, settlement period collections were much stronger than expected, reflecting a different distribution of profits among industries, together with the effect of different effective tax rates paid by those industries. Goods and services tax (GST) collections were $1.2 billion higher, as collections were extremely strong in the final quarter of 1996-97, reflecting the strength in consumer demand. Non-tax revenues were up $1.2 billion, primarily reflecting end-of-year accounting adjustments.

Table 3.4
Changes since February 1997 budget

	(billions of dollars)
February 1997 budget deficit target	**19.0**
Budgetary revenues	**-5.4**
Personal income tax	0.0
Corporate and other income tax	-1.9
EI premiums	-0.2
GST	-1.2
Other excise and sales taxes	-0.9
Other revenue	-1.2
Program spending	**-4.2**
Major transfers to persons	-0.7
Major transfers to other levels of government	0.0
Direct program spending	-3.4
Public debt charges	**-0.5**
1996-97 outcome	**8.9**

Note: Positive sign indicates an increase in the deficit.
Negative sign means a decrease in the deficit.

Most of the lower program spending (down $4.2 billion) was attributable to much lower direct program spending (down $3.4 billion), primarily attributable to lower-than-expected end-of-year accounting adjustments. Changes in operating procedures in recent years have permitted departments to carry forward a portion of unused but committed funding, thereby providing more cost-effective management of resources and reducing the previous incentive to end-of-year spending. In addition, accounting adjustments at year-end to recognize liabilities incurred by departments and Crown corporations were much lower than in previous years. Transfers to persons were $0.7 billion lower, primarily reflecting lower-than-expected employment insurance benefit payments.

As reported in the March 1997 *Fiscal Monitor*, the deficit for the April 1996 to March 1997 period was $9.6 billion. These results did not include the regular end-of-year accounting adjustments. Consistent with government accounting principles, these end-of-year accounting adjustments largely reflect increases to program spending to include the costs of liabilities incurred during the fiscal year for which no payments were made during the year. Some adjustments are also made to budgetary revenues, primarily reflecting cash-in-transit at year-end.

These end-of-year accounting adjustments have traditionally resulted in large deficits. Since 1988-89, there has only been one year (1991-92) in which these adjustments amounted to less than $4 billion. In other years, they have ranged between $4 billion and $6½ billion. Based on these results, it was indicated in the March 1997 *Fiscal Monitor* that the final deficit for 1996-97 would be no higher than $16 billion.

However, the end-of-year accounting adjustments resulted in a surplus of $0.7 billion. Revenues (primarily non-tax revenues) in the end-of-year period were significantly higher than in previous years, while program spending adjustments (especially those affecting direct program spending) were considerably lower.

Financial Requirements Eliminated

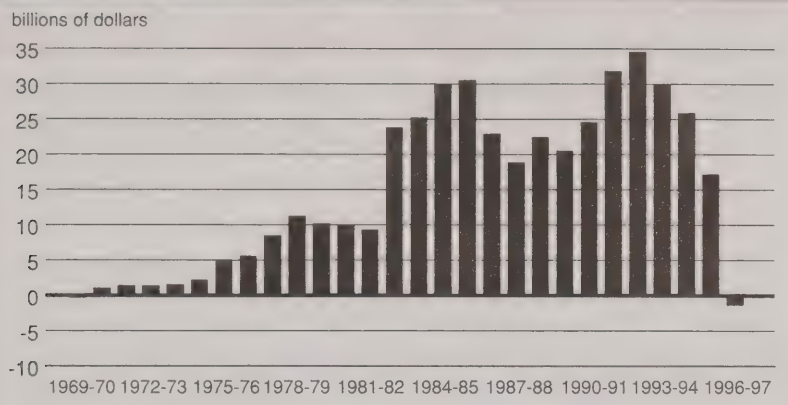
The budgetary deficit includes liabilities incurred during the fiscal year for which no cash payment was made during the course of the year. It is the most comprehensive measure of the government's financial situation.

Another measure of the government's financial performance is financial requirements. It is the difference between cash coming in to the government and cash going out. Financial requirements are usually less than the deficit as the former includes funds from internally held accounts, such as the federal employee pension accounts. Financial requirements closely approximate the amount of money that the government has to borrow in the private credit markets to finance its current operating activities. Excluding the net requirement relating to the Exchange Fund Account, there was a net financial surplus of $1.3 billion. This was the first financial surplus since 1969-70 (Chart 3.4).

There was a net requirement by the Exchange Fund Account of $7.8 billion, primarily reflecting the 1996 budget announcement to increase Canada's official reserves because of the increased flows and potential volatility in foreign exchange markets, and to bring these reserves more in line with those in other countries.

The prime objective of the Exchange Fund Account is to promote orderly conditions in the foreign exchange market for the Canadian dollar. Although the Account is consolidated within the government's financial statements, the activities of the Account are not reflective of the government's underlying financial position.

Chart 3.4 Financial requirements/surplus



As a result, total financial requirements, including the transactions of the Exchange Fund Account, amounted to $6.5 billion, down from a net requirement of $21.9 billion in 1995-96.

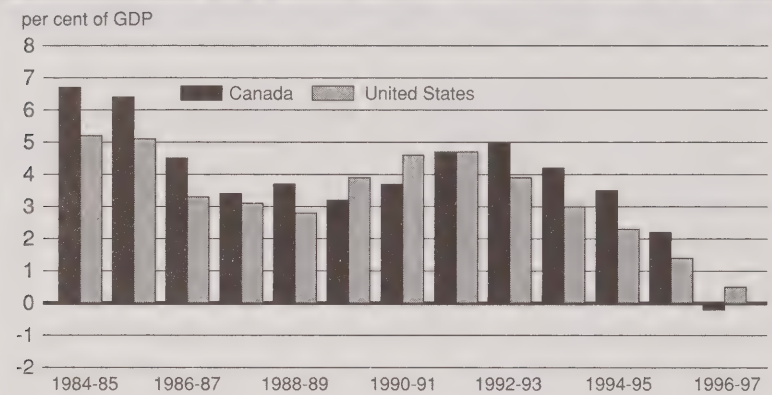
A financial surplus can be used to retire some of the government's marketable debt and/or increase cash balances. The government's net public debt stood at $583.2 billion at the end of fiscal year 1996-97. Of this amount, $476.9 billion consisted of unmatured debt issued by the federal government largely in the form of marketable bonds, Treasury bills and Canada Savings Bonds. Most of the rest was in the form of non-market liabilities related to federal employee pension accounts.

In 1996-97, the financial surplus, excluding the Exchange Fund Account, was primarily used to retire some marketable debt and to increase cash balances, to ensure that the government had sufficient cash to manage its operations in the first few months of 1997-98.

In the first five months of 1997-98 (April to August), the government retired $11.0 billion of its marketable debt, primarily Treasury bills. This retirement of marketable debt resulted from a reduction in cash balances of $5.7 billion, a net change in Exchange Fund Account transactions of $3.9 billion and a financial surplus, excluding exchange fund transactions, of $1.5 billion. Cash balances can exhibit wide fluctuations, especially at the beginning and end of each fiscal year. However, with the improvement in the overall budgetary situation, the government should be in a position in the future to continue to retire its marketable debt – a major milestone in Canada's fiscal recovery.

Most industrialized countries present their budgets on a basis that is more comparable to financial requirements than to the public accounts measure of the budgetary deficit. For example, the Unified Budget Balance for the United States' federal government is broadly comparable to financial requirements. Whereas there was a financial surplus of $1.3 billion in 1996-97 for Canada, in the U.S. the deficit is estimated to be $37 billion (0.5 per cent of GDP) by the Office of Management and Budget (Chart 3.5).

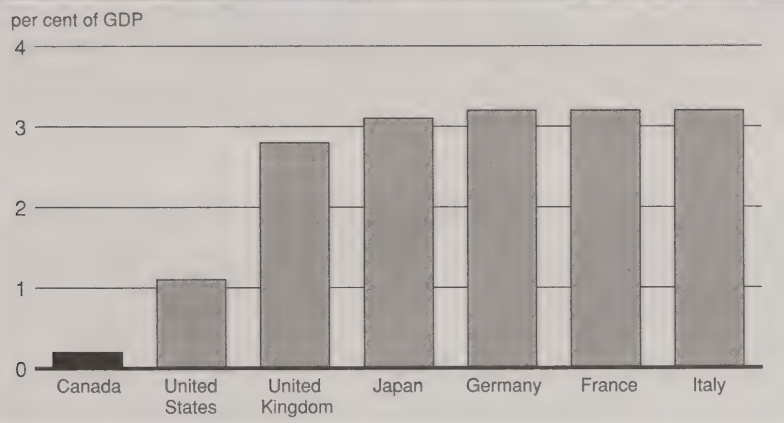
Chart 3.5 Canadian financial requirements/surplus and U.S. deficit



The federal government's main fiscal measure – the public accounts deficit – is not only the most comprehensive but is also more strict than the financial requirements measures adopted by other countries. This means that Canada's fiscal performance on a public accounts basis is not strictly comparable to that in other countries. In addition, international fiscal comparisons are complicated by the fact that fiscal responsibilities of each country can be shared differently among the various levels of government. It is for these reasons that national accounts data for the total government sector (federal, provincial-local-hospital, and the Canada and Quebec pension plans) are often used for international fiscal comparisons, as these data are broadly consistent across countries. These are the data used by international organizations, such as the Organization for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF), when presenting and commenting on international fiscal developments.

In its June 1997 Economic Outlook, the OECD estimated that Canada will have the best fiscal performance in 1997 among all Group of Seven (G-7) countries (Chart 3.6). This stands in sharp contrast to the situation in 1992, when Canada's total government deficit stood at 7.4 per cent of GDP, almost double the G-7 average of 4.0 per cent and the second highest in the G-7.

Chart 3.6 Total government deficit in G-7 countries – 1997



Fiscal Guidelines and Ongoing Challenges

Since first coming to office in 1993, the government's ultimate fiscal objective has been to restore fiscal health by balancing the budget. As an interim step to this objective, it set as a target the reduction of the deficit to 3 per cent of GDP by 1996-97. Implicit in this objective was the need to halt the rise in the debt-to-GDP ratio and to put it on a permanent downward track.

The better-than-expected outcome for 1996-97, together with the financial results for the first five months of 1997-98 (see *Fiscal Monitor* for August 1997), clearly indicate that the deficit will continue to decline in 1997-98. The government is now committed to the achievement of a balanced budget no later than 1998-99. Updated projections for 1997-98 and 1998-99 will be provided in the 1998 budget.

With a commitment to a balanced budget no later than 1998-99, deficit reduction targets are no longer relevant. However, the government remains committed to the pursuit of sound public finances as a basis for sustained economic growth. To this end, the government will continue to adhere to the fiscal guidelines that have proven to be so successful to date:

- budget planning will continue to be based on prudent economic assumptions; and
- budget projections will continue to include a sizeable Contingency Reserve.

A two-year planning horizon will continue to be used but these projections will be presented in the annual budget.

The Contingency Reserve

The Contingency Reserve is included in the deficit projections primarily to cover risks arising from (i) unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and (ii) unpredictable events. The Contingency Reserve also provides an extra measure of backup against adverse errors in the economic forecast.

The Contingency Reserve is not a source of funding for new policy initiatives. In the past, any portion of the Contingency Reserve that was not required was applied to the deficit. In the future, once the budget is balanced, if it is not required for the purposes stated above, it will be used to pay down the debt of the federal government.

The better-than-expected deficit outcome for 1996-97 means the government has now reached another important milestone in its efforts to improve Canada's financial position. The federal government's net debt burden – the level of net debt relative to the size of the economy – fell to 73.1 per cent from 74 per cent in 1995-96. This marks the first significant reversal after 25 years of virtually uninterrupted increases in the debt ratio.

The fiscal challenge for Canada remains the reduction in the debt-to-GDP ratio.

These fiscal guidelines and the commitment that the budget will be balanced no later than 1998-99 will ensure that the decline in the debt-to-GDP ratio that is now underway continues. This remains the central fiscal challenge for Canada. While declining, the burden of the debt on the economy will remain high for some time, both by historical Canadian and by international standards (Charts 3.7 and 3.8).

Chart 3.7 Federal government net debt (public accounts basis)

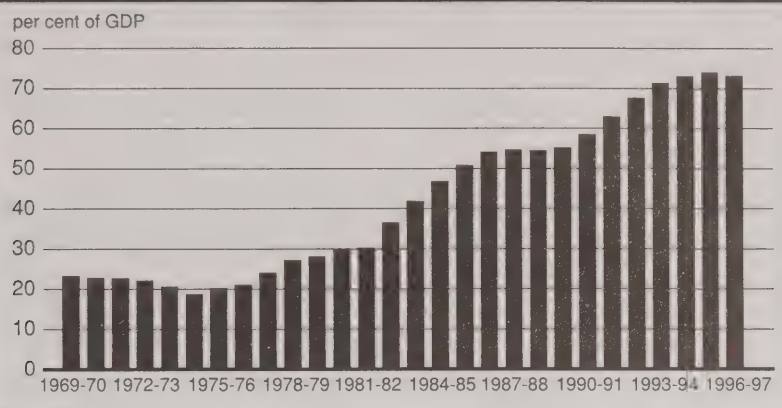
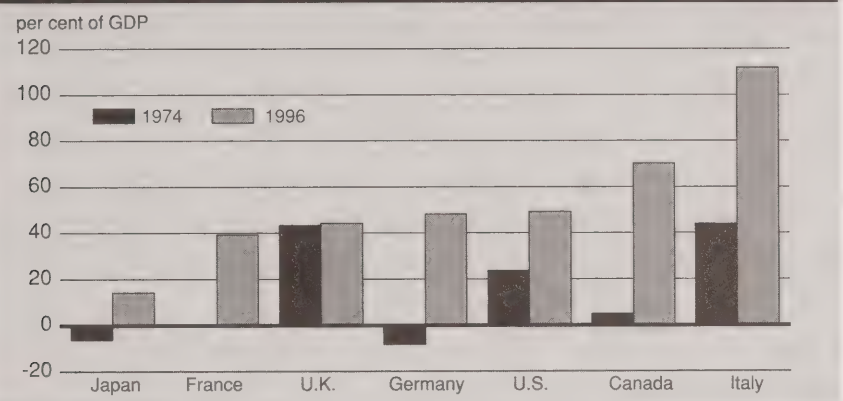


Chart 3.8 Total government net fiscal debt – G-7 countries (national accounts basis)



There is no optimal level for the debt-to-GDP ratio. What is clear is that the current level is too high and must be reduced to a more manageable level.

In the mid-1970s, less than 15 cents of each revenue dollar received by the federal government went to pay interest on the public debt. In 1996-97, however, 32 cents of each revenue dollar received was used to pay interest on the public debt. With such a large portion of every revenue dollar going to pay interest on the debt, the ability of the government to address national priorities is significantly reduced.

Moreover, the current high debt-to-GDP ratio also leaves Canada's fiscal situation extremely vulnerable to economic shocks, especially those associated with a possible run-up in interest rates or prolonged slowdowns

The current high debt-to-GDP ratio also leaves Canada's fiscal situation extremely vulnerable to economic shocks ...

in economic activity. This vulnerability means that a sustained decline in the debt-to-GDP ratio in the coming years will be necessary if the federal government is to buffer the economy from the negative effects of future economic downturns.

... the legacy left to future generations is one of sound social and economic programs ...

Reducing the debt-to-GDP ratio will ensure that the legacy left to future generations is one of sound social and economic programs, not one of high debt and high taxes. Younger Canadians have received relatively less benefit from the build-up in Canada's debt, as much of the increase has been related to past consumption of goods and services rather than spending on investments in the economy. To ensure that younger Canadians do not pay an unduly large portion of the debt, the debt-to-GDP ratio must be reduced while the generations that benefited most from its run-up are still in the labour force.

However, the demographic story does not end there. Within 40 years, the share of the population over age 65 will almost double from its current level of 12 per cent to 23 per cent. This will naturally put upward spending pressure on retirement income and health care programs. To deal with these pressures effectively, the government needs to reduce significantly the debt-to-GDP ratio ahead of time.

Finally, a high debt-to-GDP ratio restrains economic efficiency and hinders growth, thus adversely affecting the well-being of all Canadians. This is because the high levels of taxation, and concerns over even higher levels, associated with the need to service the debt discourage investment and entrepreneurship. Moreover, high levels of debt tend to push up interest rates, as a risk premium is demanded, which again discourages the investment needed to sustain growth.

Bringing the debt-to-GDP ratio down, therefore, is key to ensuring sustained long-term growth and job creation.

Bringing the debt-to-GDP ratio down, therefore, is key to ensuring sustained long-term growth and job creation. However, it will take time to achieve a signification reduction in this ratio. For example, if a balanced budget was maintained over a 10-year period, coupled with moderate economic growth and average effective real interest rates of about 5 per cent, the debt-to-GDP ratio would be about 45 per cent – the level last witnessed in the early 1980s.

The budget will be balanced no later than 1998-99. If economic performance turns out better than assumed for budget planning purposes and the Contingency Reserve is not needed, then it will be used to pay down the debt and the debt-to-GDP ratio would decline that much faster.

But this prudence in budget making will also mean that the emerging fiscal dividend will only be small at first and then grow slowly. This means that the government will be able to address a limited set of its highest priority initiatives; otherwise, it will risk putting the budget back into a deficit.

The Fiscal Dividend

The fiscal dividend is the projected surplus of total revenues over total spending that would arise in the absence of any new tax and spending actions since the 1997 budget.

The 50:50 allocation of the fiscal dividend, among expenditures to address economic and social needs and among tax cuts and debt reduction, will be used as a guiding principle for planning purposes. The annual allocation will vary from year to year. The final allocation can only be assessed after totalling all of the spending, tax and debt reduction actions undertaken in all of the budgets during the mandate and the year-end audited outcomes.

4

Building a Strong Economy and a Strong Society

Highlights

Knowledge and information are increasingly becoming the keys to economic success, presenting both challenges and opportunities.

The government is committed to building a strong economy and a strong society for Canadians in the global knowledge-based economy:

- first, by working with Canadians to build a strong economy based on knowledge, learning and innovation; and
- second, by preserving and enhancing Canada's valued education, health and social programs that have provided security and equality of opportunity for all Canadians, ensuring that no one is left behind by economic change.

Introduction

Canadians are no strangers to economic change. Canada has attained one of the highest standards of living in the world by transforming an economy focused on producing primary goods to one based on manufacturing and services. Today, Canada's economy is going through another fundamental change. The development and use of information and knowledge are increasingly becoming the principal engines of long-term growth.

The development and use of information and knowledge are fast becoming the principal engines of long-term growth.

This is not only true for what are widely considered to be "high-tech industries" such as computer software, or "high-tech jobs" like electrical engineering. Advances in knowledge are becoming increasingly important in all industries and in all jobs.

No one knows exactly how these changes will ultimately affect the economy and society. But it is clear that profound changes are underway. This transformation can be the source of major economic and societal benefits if Canadians, and their governments, make the right choices.

Canadians see many opportunities in the knowledge-based economy. New technologies are making workers of all skill levels more productive. Workers and young people are raising their levels of schooling and training because they see good skills as essential to their future economic success. Canadian businesses in all sectors of the economy are increasingly developing and adopting new ideas and techniques, thereby creating new products and services or finding new, more efficient ways of producing existing goods and services.

But Canadians are concerned that such profound economic change may undermine their economic and social well-being. Some Canadians are anxious about finding a job, or about losing their current job, or about seeing that their children acquire the education and skills that they will need to secure rewarding employment. Many people worry that the less fortunate will be left behind, ultimately increasing income inequality among Canadians. Too many Canadians are also uncertain about whether Canada's health care and retirement income systems will be there for them and their families when they need them.

The federal government is taking an active role in building a strong economy and a strong society for Canadians:

- first, by working with Canadians to build a strong economy based on knowledge, learning and innovation that will generate more and better jobs and raise living standards; and
- second, by building a strong society – through preserving and enhancing Canada's valued education, health and social programs – so that all Canadians can participate in and benefit from economic growth.

These two goals are mutually reinforcing. A strong economy builds a solid foundation of security by creating employment opportunities throughout the economy and by generating the resources needed to maintain and enhance programs that contribute to a strong society. A strong society, in turn, provides Canadians with the sense of security that allows them to adjust with confidence to the changes that are inevitable in a modern economy.

The chapter begins by reviewing the changes that are now occurring in the Canadian economy. It then describes the leadership role government must play in encouraging economic growth and translating it into a better quality of life for all Canadians.

The Growing Economic Role of Knowledge

What drives growth and creates prosperity in a modern economy? Canada has long thrived on its rich endowment of natural resources. But, in fact, the amount and nature of our raw materials has changed very little over time. What has changed, and changed dramatically, is our knowledge of how to use those resources. For example, the first known human use of iron oxide was as a pigment in cave paintings. Today, centuries later, this document is available worldwide, via the Internet, through computers that use iron oxide on their disk drives to store information. (Connect to the Internet address http://www.fin.gc.ca to access this document.)

While advances in knowledge have always been important in generating economic growth, the relative importance of new ideas has increased steadily in recent years and is reshaping the economy and society. Raw materials are still valuable, but new ideas about how to use those materials can be even more valuable, and that value can be shared more widely.

Many Canadian industries have been leaders in the development and adoption of technology ...

Many Canadian industries have been leaders in the development and adoption of technology, not just the so-called "high-tech" industries such as software, electronics and aviation. For example, new methods for managing inventories, and new technologies that have been developed to implement those ideas, are changing the way that retailers operate and the skills needed by sales personnel. Canada's resource industries are also being transformed by advances in knowledge, such as the use of satellite-generated images in resource exploration and development. Biotechnology is being used in the agricultural sector to enhance product quality, as well as to improve crop yields and disease resistance.

People are often concerned that advancements in knowledge will result in workers being replaced by computers and machines. At a time when job creation is a central concern, Canadians also worry about the ability of a knowledge-based economy to create jobs for all members of society, not just the highly skilled. New technology does tend to reduce the number of

workers needed to produce specific products. Nonetheless, there is overwhelming evidence that advances in knowledge ultimately result in a net increase in jobs. This is because new technologies lead to new products and services, a higher quality of existing products and lower production costs, all of which stimulate economic growth and job creation.

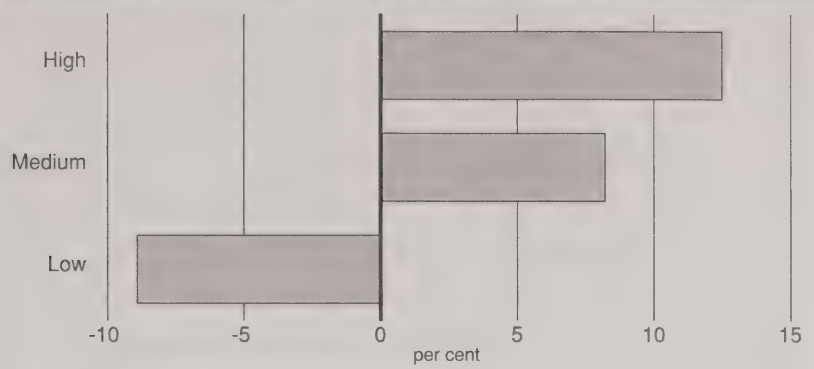
For example, the United States has enjoyed the benefits of a boom in the development and application of technology in the 1990s. This has allowed the U.S. economy to grow rapidly and to create many jobs without reigniting inflation.

Adaptation to the knowledge-based economy is a worldwide challenge. Although Canada's innovation performance has improved substantially in recent years, our major competitors have also moved forward. The key to Canada's success is for businesses, workers and governments to work together to accelerate the adoption of innovative technologies in all sectors of the economy.

That is happening. Businesses in Canada have increased their spending on research and development (R&D) by an estimated 80 per cent since the end of the 1980s. The share of manufacturers using advanced technology has increased from under 60 per cent in 1989 to almost three-quarters recently. A sign of this increased technological orientation is that the value of Canadian machinery and equipment exports is now almost as large as our automotive exports.

While Canada has only recently emerged from a difficult period over the 1990s, the benefits of this growing commitment to technology are already evident. This was reaffirmed in a recent Conference Board of Canada study entitled *Jobs in the Knowledge-Based Economy,* which found that firms that have purchased and used information technology have outperformed others in both output growth and job creation over the past decade (Chart 4.1). A study by Industry Canada entitled *Employment Performance in the Knowledge-Based Economy* also found that employment growth in Canada is increasingly related to the use and production of knowledge.

Chart 4.1 Employment growth by information technology intensity, 1986-1995



Source: Statistics Canada; The Conference Board of Canada.

As well as stimulating job creation, advances in knowledge also lead to higher real incomes. Learning to produce more, or more valuable products with the same amount of effort, raises productivity. Those productivity gains drive real income growth and a consequent improvement in living standards. Indeed, higher real incomes and the myriad of new products and services made possible by ongoing innovation afford Canadians today a standard of living their grandparents could hardly imagine.

The rise in the importance of knowledge has been accompanied by increasing integration of the world's economies. Globalization has, of course, been fostered by a worldwide move towards liberalization of trade and investment policies, but has been made possible by advances in the speed and efficiency of communications and transportation.

Globalization has added many new consumers of Canada's goods and services.

Globalization has added many new competitors in world trade. But it has also added even more potential consumers of Canada's goods and services, thereby increasing the rewards to the successful application of new ideas. By providing improved access to larger markets, trade liberalization has not only allowed Canadian producers to specialize in what they do best, it has also given Canadian firms and consumers access to new and better quality products and services at lower prices.

With the distance barriers between countries effectively diminishing and the importance of knowledge as an input to production increasing, economic activities are becoming less tied to geography and natural resource endowments and more tied to human resource endowments. The end result is not only that world demand for skilled workers is increasing,

but also that the economic fortunes of Canada's regions will increasingly hinge on their ability to provide an environment conducive to growth. Indeed, Canada's traditional appeal of plentiful natural resources is no longer sufficient on its own to attract investment, by either Canadians or foreigners. What has become all the more important to attracting new investment and production is an attractive business, work and social environment. And especially important is having a skilled, productive workforce. Indeed, a recent study by the Conference Board of Canada entitled *What Makes Technopoles Tick? A Corporate Perspective* found that, for high-tech companies, a skilled workforce was the most important influence on the decision of where to locate.

Leadership in a Global Knowledge-Based Economy

Canadians want governments that provide active leadership.

Canadians want active governments that respond to economic change by providing leadership. They do not want governments that try to turn back the clock on change because that will deny them the opportunity to benefit from economic growth. Nor do they want governments that retreat from their responsibilities to build security for Canadians and expand opportunities for everyone.

While the importance of government has not diminished, the amount of money that governments can spend on programs has decreased. How can governments do more with their limited resources? The answer is to work more effectively by focusing on key areas. Governments can no longer be all things to all people.

An effective government works with the economy and markets, not against them. For example, the privatization of Canadian National (CN) not only resulted in fiscal savings, it also freed CN to pursue new business opportunities on an equal footing with its competitors, and allowed CN to modernize and provide customers with improved services at reduced costs. In another example, to help exporters reach new markets, the government provides competitive export financing through the Export Development Corporation (EDC). By working with financial markets, EDC is able to operate on a commercial basis.

Working effectively also means recognizing that 'going it alone' is rarely good policy. That is why the federal, provincial and territorial governments have been developing a more collaborative approach to strengthening Canada's social union – work on the new National Child Benefit is an early result of this approach. The federal government now also has agreements with eight provincial and territorial governments to take full or shared responsibility for active labour market programs. Building on this teamwork approach, partnerships between the federal and provincial governments have been broadened to include the private sector in ventures such as the Canada Foundation for Innovation – an arm's length foundation investing in Canada's universities, colleges, and research hospitals.

Providing effective, focused government is essential to creating opportunities and building security for Canadians, but it is not enough. As first outlined in the 1994 *Agenda: Jobs and Growth* documents, the federal government must also provide leadership in the four areas discussed below, which are key to Canada's prosperity in the global knowledge-based economy.

Building a Sound Economic Framework

Sound fiscal management and low and stable inflation are key to a healthy economy.

A sound economic framework is an essential ingredient for sustained prosperity. A healthy economy – by fostering consumer and business confidence – is key to encouraging business investment and major consumer purchases. That requires sound fiscal management and low and stable inflation. Strong business investment ultimately stimulates growth of the productive capacity of the economy and the adoption of new technologies embodied in capital goods.

The tax system also affects the health of the economy.

Tax laws and regulations, which affect the investment and spending decisions of businesses, workers and consumers, can also have a major effect on the health of the economy. The government must therefore ensure that it develops a fair and efficient tax system to raise its revenues. This implies that: taxes reflect the ability to pay; taxes are collected in a manner that is conducive to creating jobs and growth; and taxes that are owed are indeed paid. This government has a long-standing commitment to tax fairness, which it elaborated in the 1996 and 1997 budgets.

The federal government's approach to improving Canada's tax system will continue to be guided by two principles. First, the government will continue to provide targeted tax relief to deal with the most pressing social and economic stresses. Second, as fiscal room becomes available, the tax burden will be reduced in ways that not only ensure fairness, but that also will yield significant benefits in improving jobs and growth.

Building Opportunity Through Knowledge and Innovation

A sound economic framework is the foundation of any prosperous economy, but building a strong economy based on knowledge and information also requires the active participation of individuals, businesses *and* governments. Businesses obviously are motivated to develop and apply knowledge through investment in research and development. However, the returns from advancements in knowledge not only accrue to the businesses that make the investment, but can also spill over to the rest of the economy – for example, through better quality products and services at lower prices – thereby benefiting society as a whole.

The government therefore has a leadership role to play in promoting knowledge and innovation in several ways.

- First, laws and regulations can have a profound influence on the generation and use of knowledge. For example, intellectual property laws strike a balance between encouraging the development of new ideas and promoting their diffusion throughout the economy. This works particularly well for encouraging late-stage research and development.

- Second, federal government programs are needed to encourage the earlier stages of research when openness and collaboration are essential to progress and patent protection may not be possible. The federal government currently spends just over $5 billion annually on science and technology-related activities. Many programs are run in co-operation with the private sector, such as in the area of space technology development. The federal government currently funds 21 per cent of all R&D performed in Canada, including transfers to businesses and universities to finance basic and applied research. The federal scientific research and experimental development (SR&ED) investment tax credit – with claims amounting to

$1.3 billion annually – is also an important federal contribution to encouraging private sector research in Canada.

■ Third, world-class research facilities have become key to attracting investment in areas of high growth potential and to training and retaining highly skilled research personnel in Canada. The federal government's endowment of the Canada Foundation for Innovation – in partnership with the private sector, provincial governments and universities – is helping modernize research facilities at Canadian post-secondary education institutions and research hospitals in the areas of science and engineering, health and the environment.

World-class research facilities have become key to attracting investment.

■ Finally, the federal government has a role to play in supporting the generation and, especially, the diffusion of knowledge throughout Canada's diverse industries and regions. In particular, Canada's small and medium-size businesses can benefit by improving their access to leading-edge technology, financing and markets.

The growing importance of the Internet prompted the government to develop programs to assist rural and aboriginal communities, schools, libraries and businesses to connect to the information highway. For example, the SchoolNet program is providing young Canadians with vital access to, and training and experience in, new information technologies. Making Canada the most connected nation in the world will provide Canadians with new opportunities for learning, interacting, transacting business and developing their economic and social potential.

Improved access to international markets is also key to the development of knowledge by encouraging Canadian firms to specialize in what they do best. It also encourages the use of new and better quality inputs at lower prices to take advantage of new market opportunities. The federal government's primary role in this area is to ensure that a fair set of rules governs economic relations with all of Canada's trading partners. To that end, formal trade agreements are very important in safeguarding the interests of smaller open economies like Canada's. In particular, the federal government is continuing to pursue multilateral and bilateral trade agreements such as the negotiations that resulted in the creation of the World Trade Organization (WTO) to oversee and guide the expansion of world trade.

Multilateral agreements ensure that fair rules govern trading relationships.

The government is also supporting the private sector in securing and expanding Canada's access to world markets for its products and services, through an aggressive international trade promotion strategy led by the Team Canada trade missions.

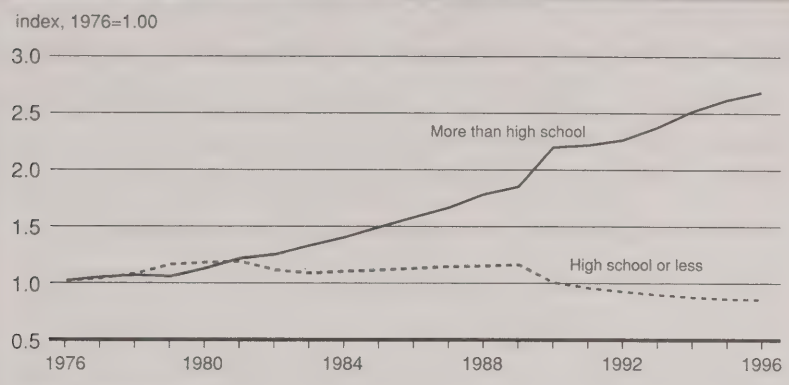
Building Opportunity Through Learning

The changes that are taking place in the economy are altering the way Canadians work and the skills they need to find and keep a job. Although this has been a fact of life for more than a century, the fortunes of workers turn increasingly on the skills they already possess or are prepared to acquire. Canada cannot afford to leave people behind while the rest of the economy moves forward. History has proven that education and training are important not only to the economy, but to people as well. Most importantly, education and training are the best tools to reduce income inequality, by giving people the skills needed to seize the opportunities available in a strong, modern economy. In this way, they provide both a solid foundation for a strong economy, and a society that is fairer and more inclusive.

Job growth has been faster for those with higher skills.

The premium that the knowledge-based economy has placed on skills is reflected in Canada's employment statistics. Over the past two decades, job growth has been faster for those with higher skills (Chart 4.2). With the number of jobs for persons with less than high school education shrinking rapidly, their unemployment rate is now double that of persons with a university degree. Moreover, given the relatively weak demand for low-skilled workers, their employment earnings are falling behind those of more educated and skilled workers, risking a polarization of incomes that could damage the social fabric. The rising importance of education and skills is only partly due to the creation of new "high-skill" jobs in "high-tech" industries. There has also been a steady increase in skill requirements in all sectors of the economy and in most types of jobs – from machinists to warehouse workers, from farmers to loggers.

Chart 4.2 Employment growth by educational attainment, 1976-1996



Source: Statistics Canada.

Canada's young people are particularly affected by the transition to a knowledge-based economy. Economic change has increased the advantage that young people can gain from education. As a result, many young people are staying in school longer. That is why today's young Canadians are, on average, the best educated, most literate and most technologically adept in Canada's history.

But today's young people face real challenges. Too many still do not even complete high school. Many more do not have the financial resources to enter into post-secondary education or face the prospect of graduating with difficult debt loads. Moreover, just as technological change has increased the value of education, it has also increased the value of on-the-job experience. This has made it particularly difficult for young people, who typically lack work experience, to find and keep their first jobs.

In order to realize their economic and social goals, governments must support education, skills development and the acquisition of work experience to help Canadians of all ages. A more educated and skilled workforce is better at developing, diffusing and adopting the advances in knowledge that are the key to economic growth. Better skills are also a powerful force for improving income equality and ensuring that all Canadians can participate in, and benefit from, economic growth. This is especially crucial to a shared prosperity when that growth is increasingly dependent on the application of knowledge.

No single sector of society or any one order of government has all the answers to meet this challenge successfully. All must contribute. The provincial governments are responsible for the delivery of education services and much of skills training. The federal government provides assistance to Canadian students and their families in coping with the rising cost of education. This help is not limited to young people; it increasingly will promote life-long learning, in recognition that many workers who have left the formal education system will need to enhance their skills or learn new ones.

- First, the federal government helps the post-secondary students of today face the substantial costs of post-secondary education.
- Second, the federal government helps recent graduates cope with the burden of repaying their student loans.
- Third, the federal government helps the families of the post-secondary students of tomorrow to save for the post-secondary education of their children.

This help is provided through several channels.

- First, the federal government provides tuition and education credits, which may now be carried forward indefinitely until students have sufficient income to make use of them. In the 1997 budget, the education credit was doubled from $100 to $200 per month of full-time study.
- Second, the Canada Student Loans Program helps to ensure the widest access to higher education by providing more than $1 billion in new student loans each year for post-secondary education. The loan limits were increased to reflect the rising costs of education. More recently, changes were made to the program to expand interest relief for borrowers encountering difficulty in repaying their loans. Scholarships made available by the federal granting councils provide financial assistance to students to complete their studies and add to their research experience.
- Third, resources and flexibility are provided through the tax system to encourage parents to save for their children's post-secondary education in registered education savings plans (RESPs). These were recently enriched in the 1997 budget.

More will be done. The government will be introducing special grants for needy students with dependants. The government is also exploring with the provinces and other interested parties the option of introducing income-related repayment schemes and other changes for student loans. Most recently, the Prime Minister announced the creation of the Canada Millenium Scholarship Endowment Fund to reward academic excellence and provide thousands of scholarships for low- and middle-income Canadians.

The federal government is also helping young people who face difficulties in making the transition to a career-oriented job. Through its recently expanded youth employment strategy, the federal government promotes work experience for young Canadians in partnership with aboriginal communities, the private sector and community organizations. For example, the federal public sector Youth Internship Program will invest $90 million over three years to provide, in partnership with Career Edge and the YMCA, essential work experience and skills to 3,000 young Canadians who are underemployed or "at risk" of unemployment.

The government will work with the provinces, the private sector and communities to develop a new mentorship program, and to introduce a new community-based program for those young Canadians who are most at risk of unemployment because of their lack of skills and low education. Internship programs will be expanded and aboriginal youth centres will be created to help off-reserve aboriginal young people who are unemployed.

Building Security Through a Strong Society

Canada's future prosperity depends as much on our valued education, health and social programs as it does on our economic policies. Good public services and strong social programs are key to ensuring that Canadians have a sense of security and confidence in their well-being and future prospects and to helping them to pursue their economic objectives. While substantial progress has been made in invigorating our economy and in securing our social programs, more needs to be done in several areas.

Helping Canadian families give their children a good start in life is one of the most important investments Canada can make in its social and economic future. Most Canadian children are doing well and are physically, emotionally and socially healthy. But the fact remains that opportunity denied in childhood too often means chances lost as an adult. The experiences of Canada's children, especially in the early years, influence their health, their

Helping Canadian families is one of the most important investments Canada can make.

well-being, and their ability to learn and adapt throughout their entire lives. The 1997 budget allocated $100 million to expand the Community Action Program for Children and the Canada Prenatal Nutrition Program.

Unfortunately, some government programs aimed at providing essential support to low-income families have inadvertently formed a "welfare wall" so that some parents may be financially worse off in the workforce than remaining on social assistance. This affects the opportunities available to their children.

To break down the welfare wall, the federal and provincial governments are developing a National Child Benefit System, designed to help prevent and reduce child poverty and ensure that families will always be better off by working. The foundation for this system is an enriched and redesigned Canada Child Tax Benefit and Working Income Supplement. The federal contribution to this benefit was increased by $850 million a year in the 1997 budget, bringing the total annual federal contribution to $6 billion. The federal contribution will increase at least $850 million during this government's mandate. In turn, provinces and territories will invest in complementary programs to improve work incentives and services for low-income families with children.

The federal and provincial governments will also continue to work together on a National Children's Agenda. As part of this, the government has committed in the Speech from the Throne to undertake three new initiatives: the creation of Centres of Excellence on Children's Well-being, the extension of the Aboriginal Head Start Program on reserve, and monitoring and reporting on the readiness to learn of Canadian children.

The government is firmly committed to preserving the health care system and ensuring that it meets the needs of the future. Canada has one of the best health care systems in the world, an achievement of which Canadians are justifiably proud. Under medicare, high quality health care services are available to all Canadians based on need, not ability to pay. Canadians do not have to fear catastrophic financial losses due to illness in the family. Medicare also makes a significant contribution to the competitiveness of Canadian firms, which do not have to fund expensive hospital and medical coverage for their employees as is the case in some countries.

The federal government is committed to ensuring universal and accessible medicare.

Since the 1990s, provincial governments in Canada have had to restrain the growth of health care costs, and likewise the federal government has had to cut its transfers to the provinces. This has lead to an increasing anxiety among Canadians about the present state and future of Canada's medicare system. The federal government recognizes that this restructuring has been difficult for Canadians and therefore it will be raising the cash floor of the Canada Health and Social Transfer (CHST) from $11.0 billion to $12.5 billion. Over five years, this will provide an additional $6 billion of funds to the provinces for health care and other social priorities. It will also ensure that the federal government has the means to enforce the principles of universal and accessible medicare for all Canadians. The 1997 budget allocated $300 million for new health initiatives and will be pursuing further health initiatives as recently outlined in the Speech from the Throne.

The retirement income system is working well, but it is under stress.

Ensuring that Canada's seniors have an adequate retirement income is one of the most important initiatives ever undertaken in this country. Although Canada has a sound and comprehensive retirement income system, it will increasingly come under stress as the baby-boom generation retires. While there are more than five working-age Canadians for every retired person today, by 2030 there will be only three.

To ensure that the retirement income system remains affordable and sustainable, the government has recently introduced legislation to change the Canada Pension Plan (CPP) by: moving to fuller funding now so that contribution rates will not exceed 10 per cent for future generations; improving the return on the CPP fund through a new investment strategy; and slowing the growth in costs by changing how some benefits are calculated and administered. The government is currently consulting Canadians on a new Seniors Benefit that would better target government support and moderate the growth of costs. Canadians can now have confidence benefits will be there for them when they retire.

Conclusion

As we move towards the 21st century, the growing importance of knowledge offers all Canadians great challenges and great opportunities. Modern communications have caused distance to lose much of its economic meaning, and skills are becoming the most important raw materials of all. This transformation can be the source of a widespread increase in living standards if individuals, businesses and governments make the right choices.

That is why the federal government is committed to providing leadership in helping Canada succeed as a knowledge-based economy and society. The government understands that a country with a rich natural resource base can be truly successful only if it also develops a rich base of knowledgeable and skilled workers. Yet, a country with a rich base of knowledgeable and skilled workers will succeed only if its economy creates the opportunities needed to develop and apply those skills in an innovative workplace. And these opportunities will only be fully seized if Canadians have the security needed to make the necessary adjustments confidently. This means ensuring that Canada's valued health, education and social programs are there for those who need them. The federal government is determined to build a society of skills, innovation and security, where each element reinforces the other, creating and sustaining jobs and raising the Canadian standard of living.

5

Conclusions and Main Issues

Over the last four years, the federal government has pursued a strategy of restoring Canada's fiscal health as a means to creating the conditions for stronger economic growth and job creation and sustaining the long-term viability of Canada's health, education and social programs.

The payoff to this strategy is clearly evident. The federal deficit has declined sharply, and the government is committed to achieving a balanced budget no later than 1998-99. The economy is now growing at a strong pace. Canada's overall economic prospects are better than at any time in the past 25 years.

The challenge now is to build on these achievements so as to assure Canadians of a strong economy and strong society for the future. The key lies in maintaining fiscal health while at the same time making strategic investments to build opportunity and security for all Canadians.

The improvement in economic conditions will make the government's other strategic investments more effective. For example, investments in skills training are more effective when participants find better job opportunities when they graduate. Similarly, programs to assist businesses to acquire new technologies are made more effective when low interest rates make it less costly for firms to make new investments.

The government's strategy of improving economic conditions and making strategic investments complements the investments being made by businesses and individuals. Collectively, these efforts will increase the capacity of the economy to grow, and the capacity of Canadians to adapt

to the changes brought on by the knowledge-based economy. The end result will be more and better jobs.

The public consultations that took place over the last four years were instrumental in determining the government's economic and fiscal strategy, and its unquestionable success. In preparing the first budget of its second mandate, the government is seeking the views of Canadians on ways to consolidate the fiscal progress achieved, and what government can do to help Canadians prosper in the new economy.

The House of Commons Standing Committee on Finance will be asked to consult with Canadians and advise on the following questions.

- First, what economic assumptions, including prudence factors, should be used for 1998 and 1999 in planning for the 1998 budget?
- Second, what are the appropriate new strategic investments and changes to the tax system that would allow the government to best achieve its priorities?
- Third, what is the best way that the government can help to ensure that there is a wide range of job opportunities in the new economy for all Canadians? Areas of discussion could include how government can best support Canadians in acquiring the education and skills needed to thrive in a knowledge-based economy, and how government can best foster the application of knowledge across the economy.

Annex 1

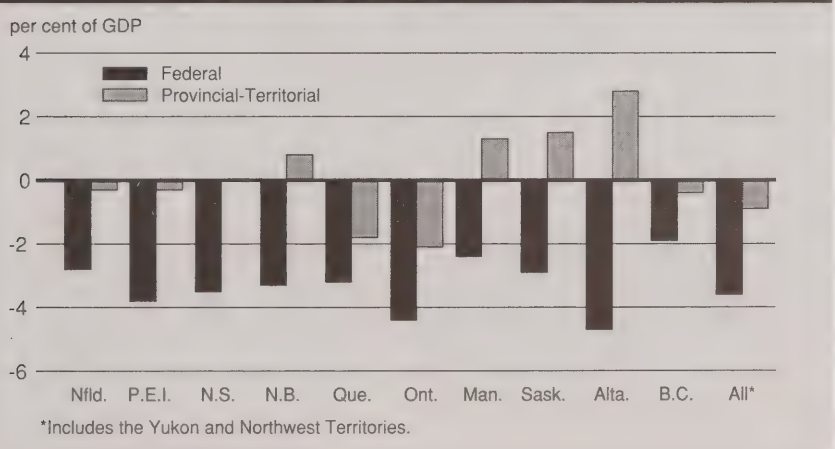
Improvement in Provincial Finances

The fiscal turnaround at the federal level is critical to Canada's financial health. But this represents only one element of the more general improvement in the overall fiscal situation of governments in Canada.

This annex provides an assessment of the fiscal progress made at the provincial-territorial level.

The provincial-territorial budgetary balance deteriorated very rapidly in the early 1990s, reaching a peak deficit of $25.2 billion in 1992-93, compared to a deficit of less than $5 billion prior to the 1990-1991 recession. However, since the recession, provinces have introduced medium-term fiscal plans to address their fiscal balances.

Chart A1.1 Surplus/deficit (-) (public accounts basis)



*Includes the Yukon and Northwest Territories.

These plans have met with considerable success. Five provinces are expected to report budgetary surpluses in 1996-97. The aggregate provincial-territorial deficit in 1996-97 is estimated to be $7.2 billion, a decline of over 70 per cent from its peak in 1992-93. Moreover, all jurisdictions are committed to eliminating their deficits by the end of the current decade.

Various fiscal consolidation strategies have been adopted at the provincial level. British Columbia targeted a reduction in real per capita spending. Alberta cut program spending without introducing any new taxation initiatives. Other jurisdictions, such as Saskatchewan, implemented program spending reductions in conjunction with some revenue-enhancing measures. Ontario reduced both program spending and personal income taxes.

Reflecting the accumulation of deficits since the beginning of the 1990s, the net debt-to-GDP ratio of the provincial-territorial sector increased from 16 per cent prior to the last recession to a peak of 28.4 per cent in 1995-96. However, the aggregate provincial-territorial debt burden declined in 1996-97 for the first time since 1988-89.

The federal net public debt-to-GDP ratio rose from about 55 per cent prior to the last recession to 74.0 per cent in 1995-96, before declining to 73 per cent in 1996-97. As a result, the combined federal-provincial-territorial debt-to-GDP ratio rose from about 70 per cent prior to the 1990-91 recession to over 100 per cent by 1995-96.

The much higher debt-to-GDP ratio faced by the federal government underscores the much more difficult fiscal challenge facing the federal

Chart A1.2 The evolution of the net debt-to-GDP ratio (public accounts basis)

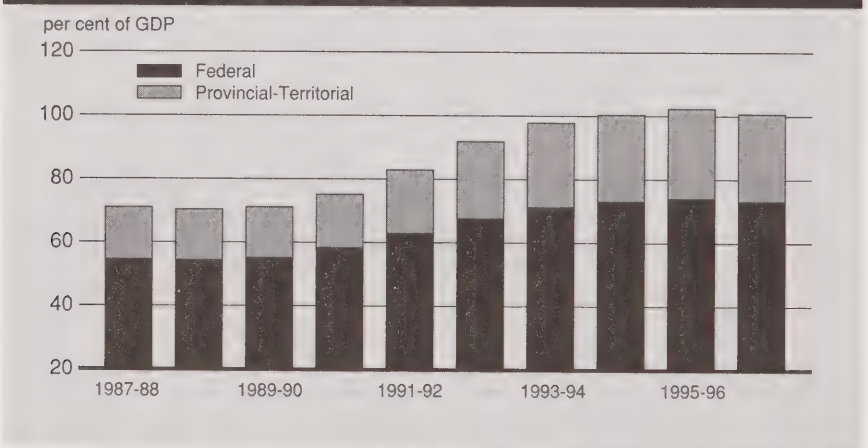
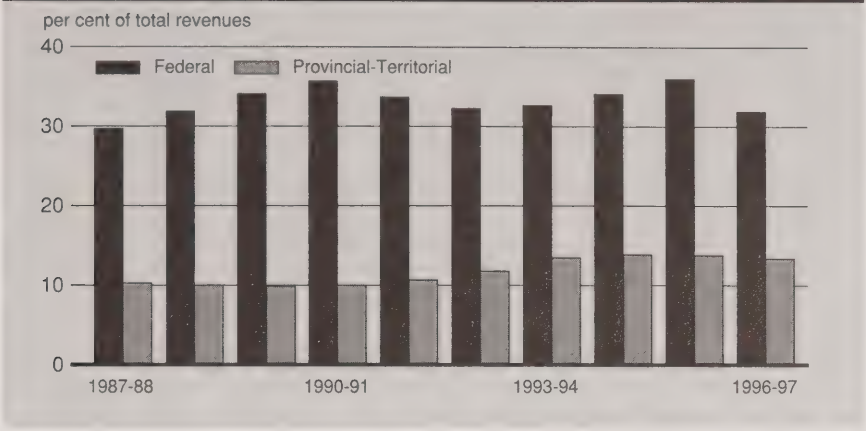


Chart A1.3 Debt charges as a proportion of total revenues (public accounts basis)

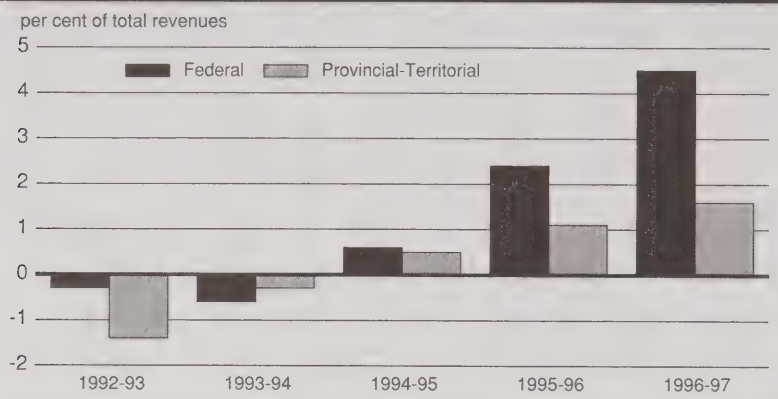


government compared to that of the provinces and territories. For example, debt charges at the federal level absorbed about one-third of every dollar collected in revenues, sharply higher than the 14 cents of each dollar at the aggregate provincial-territorial level.

In order to break the vicious cycle of debt dynamics, all Canadian governments had to engineer increasing operating surpluses – the difference between total revenues and program spending. In 1993-94, the federal government had an operating deficit of equivalent to 0.6 per cent of gross domestic product (GDP). By 1996-97, the federal government had generated an operating surplus of 4.5 per cent of GDP. Provincial-territorial governments also implemented measures that led to the realization of significant operating surpluses. From a deficit position of 1.4 per cent in 1992-93, the provincial-territorial operating balance reached a surplus of 1.6 per cent in 1996-97. The higher level of indebtedness and debt servicing costs of the federal government mean that it has had to generate operating surpluses almost three times as large as those of the provinces and territories in order to achieve a similar deficit outcome.

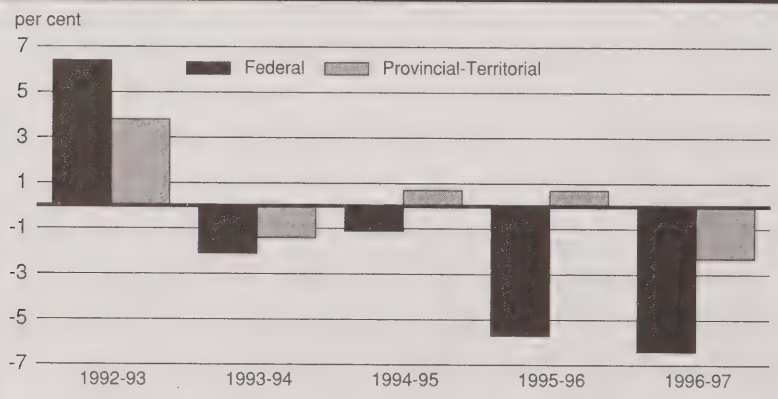
Collectively, program spending at the aggregate provincial-territorial level is larger than program spending at the federal government level. From a peak of $140.2 billion in 1992-93, the aggregate provincial-territorial program spending fell to $137.1 billion in 1996-97, a decline of $3.1 billion, or 2.2 per cent. In contrast, federal program spending has declined in each of the last four fiscal years, falling from $122.6 billion in 1992-93 to $104.8 billion in 1996-97, a decline of $17.8 billion, or 14.5 per cent.

Chart A1.4 Federal and provincial-territorial operating balances (public accounts basis)



Given the amount of fiscal action required to address the federal fiscal situation, federal transfers to provinces could not be exempt from restraint. Cash transfers to the provinces and territories amount to over 20 per cent of federal program spending. However, as demonstrated in Chapter 3, the reduction in total entitlements to the provinces and territories over the 1993-94 to 1996-97 period was considerably less than the reduction in federal direct program spending. Furthermore, the reductions in transfers to the provinces and territories primarily occurred in 1996-97, a full year later than the reductions to federal direct program spending. This delay was put in place to allow provinces and territories time to adjust to the reduction in total entitlements.

Chart A1.5 Annual growth in federal and provincial-territorial program spending (public accounts basis)



Furthermore, the improvement in the federal fiscal situation has generated positive benefits for all provinces in the form of lower debt servicing costs. The interest rates paid by the provinces and territories cannot be lower than that charged to the federal government. The dramatic turnaround in federal finances has played an important part in getting interest rates down for all borrowers in Canada. These low interest rates benefit both the private sector and governments, which have new borrowing requirements or must refinance their debt.

Annex 2

Fiscal Outlook: Sensitivity to Economic Assumptions

Sensitivity to Changes in Economic Assumptions

Estimates of the main fiscal aggregates are sensitive to changes in economic assumptions – particularly to the level of nominal gross domestic product (GDP) and interest rates. The following sensitivity estimates capture the direct fiscal impacts of changes, one economic variable at a time. These are partial calculations. For example, in the nominal income sensitivity estimate, there is no feed-through of the change in nominal income to other variables, such as interest rates and unemployment.

Sensitivity to Changes in Nominal Income

A 1-per-cent increase in the level of nominal GDP leads to higher tax bases and thus higher revenues. The ultimate deficit impact would depend on the source of the increase in nominal income. The most favourable impact on the fiscal situation would occur if all of the increase in nominal GDP resulted from increased real output. Revenues would be higher and borrowing costs lower. Interest rates would be relatively stable.

If, however, the improvement in nominal GDP was solely due to inflation, then some of the positive impact of government revenues would be offset by higher spending on those programs indexed to inflation. Higher inflation would also likely raise interest rates.

Table 1
Fiscal sensitivity analysis:
1-per-cent increase in nominal income

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue increases	1.2	1.3	1.4	1.6
Expenditure reductions	0.1	0.2	0.1	0.1
Deficit reduction	1.3	1.5	1.5	1.7

Assuming the increase in nominal income comes solely from an increase in output with no impact on interest rates, the deficit would be lowered by $1.3 billion in the first year, rising to $1.7 billion after four years (Table 1).

Sensitivity to Changes in Interest Rates

In contrast to the uncertainties of the sensitivity of the deficit to changes in nominal GDP, the direct impact of interest rate changes on public debt charges can be calculated with considerably more precision.

A sustained 100-basis-point increase in all interest rates would cause the deficit to increase by $1.0 billion in the first year (Table 2). As longer-term debt matures and is refinanced at the higher interest rates, the negative impact on the deficit increases, such that by year four, the deficit is about $2.6 billion higher.

Table 2
Fiscal sensitivity analysis:
100-basis-point increase in all interest rates

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue increases	0.5	0.5	0.5	0.5
Expenditure increases	1.5	2.4	2.8	3.1
Deficit increase	1.0	1.9	2.3	2.6

These estimates are somewhat lower than estimates contained in previous years. This is because the government has increased the fixed-rate portion of the debt (the percentage of the gross debt issued as longer-term fixed-rate instruments) from about 50 per cent in the late 1980s and early 1990s to 65 per cent today.

The establishment of a prudent debt structure that has more stable long-term financing is one of the key steps to putting Canada's financial house in order, and is essential to maintaining investor and credit rating agency confidence. Canada's past reliance on short-term debt was noted by market participants and credit rating agencies – a concern which, if unaddressed, could have raised Canada's overall cost of debt. By ensuring the government meets its objective of raising stable, low-cost funding, a prudently structured debt stock benefits all taxpayers and brings Canada into line with international standards. For further information, refer to the *Debt Operations Report*, Department of Finance, November 1996.

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October 14, 1998

The Economic and Fiscal Update

strong economy and secure society

Canada

October 14, 1998



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Presentation

by the
Honourable Paul Martin, P.C., M.P.

to the
House of Commons
Standing Committee on Finance

October 14, 1998
CHECK AGAINST DELIVERY

Mr. Chairman,

Let me thank you and the members of this committee for the opportunity to be here today.

Our country will begin a new century – a new millennium – in little more than 400 days. The decisions we make now – the path we choose to follow – will in no small way determine Canada's economic strength and confidence as we enter that new era.

Global Economic Developments

Last week, a series of important international meetings were held in Washington. The G-7 – finance ministers and central bank governors of the United States, Japan, Germany, the United Kingdom, France, Italy and Canada – met, followed by meetings of the International Monetary Fund (IMF) and the World Bank. These were significant discussions. And the reason is clear.

The international economy has entered a period of turmoil not seen for a very long time – and it is far from easy to predict how long the uncertainty and volatility will last.

Comparatively, Canada, while not immune to the economic volatility beyond our borders, is well positioned to weather the storm. Consider what is happening elsewhere.

Much of the globe is now in recession. The IMF's estimate for overall world economic growth this year is now down to 2.0 per cent from 3.1 per cent only a few months ago.

Japan, the world's second largest economy, is in recession.

Korea, Malaysia, Indonesia and Thailand – once known as the Asian Tigers – are in difficulty. Their economies are predicted to shrink, on average, by over 9 per cent this year.

Major economies in Latin America – including those of Mexico, Brazil and Venezuela – have been badly shaken by world capital markets.

Worrisome political and economic chaos has gripped Russia, with the system of government itself showing signs of very serious stress.

People everywhere have been disconcerted as stock markets around the world have tumbled from their recent highs.

Many parts of the world are suffering as a result of the inability to borrow the money they need to grow, a drying up of resources that is bringing whole economies to a virtual halt.

The prices of world commodities – natural resources – have fallen by nearly 30 per cent since their peak at the end of 1996. In real terms, they are now close to their lowest level since the early 1970s.

Millions upon millions of people in the developing world are being thrown into poverty – and families throughout the developed world wonder if their well-being and security are now at serious risk.

These facts and others fill the headlines. But they also illustrate serious fault lines – fault lines that must be fixed.

Until recently we've seen – and benefited from – several years of significant economic expansion around the world.

Now we are seeing globalization's other face.

In an unprecedented fashion, negative developments in far-off corners of the world are having immediate repercussions everywhere. Very clearly, the global economy has entered uncharted waters.

This might well be the first real test of the stability and sustainability of globalization.

Let there be no doubt. Open markets and economic growth have brought previously unheard of prosperity to literally hundreds of millions of people around the globe. And that successful quest for a higher standard of living can, and will, resume once the current challenges are met.

The instability that we are now seeing in so many countries was inevitable at some point.

Faulty domestic financial systems, inadequate oversight and regulation, political rigidity, structural economic flaws, distorted competition and cronyism – these and other faults could be papered over, but not forever.

The foundation was weak and eventually bound to crack – and now it has.

The global challenge is to repair the damage, to build a durable foundation – to take the measures necessary to ensure that the world economy can restore and maintain sustained growth.

The pursuit of protectionism is no answer. Indeed, it would be a grave error. Markets must remain open. In order to move on to the next stage of growth, our challenge is to mend and reinforce the fabric of the global economy, not to abandon it.

As we speak, the challenges domestically for many economies are profound – and they are profound as well for the international community and its institutions.

The discussions we held in Washington focused on these clearly difficult, complex and very significant issues – and they marked an important first step in building the new foundation we now need.

We agreed that the Bretton Woods institutions, which have served the global economy well for over 50 years, are now in need of renovation. We reached a consensus that the time for diagnosis is over. Meaningful solutions have been advanced. Job one is now to implement them.

Canada has put forward a six-point plan to deal with the international situation. Our initiatives were well received by the global community in Washington last week and many of our specific suggestions will form the building blocks of the new financial architecture.

All of us, G-7 and emerging markets alike, agreed on the absolute necessity of creating and maintaining domestic policy environments conducive to steady, non-inflationary growth.

We made progress in Washington, but not nearly enough. More must be done and we must act quickly because, in the end, this is about protecting people. Ultimately, they are the ones who will suffer if strong and resolute action is not taken.

Mr. Chairman, no country, no matter how large, can prevent or control the kind of worldwide economic turbulence we are experiencing today. And no economy – no matter how strong – can shield itself fully from its consequences.

This is especially true for Canada, a country that always has, and always will, depend on trade for so many of its jobs and so much of its prosperity.

The global economy will come through this difficult period, as it has before. Canada is particularly well placed, with our public finances restored to health.

But let us make no mistake. It is likely to be a year of heavy weather ahead. The winds of financial turmoil will continue to blow, and Canada is going to feel the effects – even if we are well prepared, and even if we are only at the edge of the storm.

Our Challenge and Our Plan

In the face of these forces, we have spoken about what our responsibilities are internationally. The question now arises as to what our responsibilities are here at home. Our view is crystal clear.

It is to act in the short term but to always look to the long term.

It is to continue to put in place the kind of robust policy framework that can cushion the impact of global shocks – and, at the same time, sustain and strengthen the social safety net on which all Canadians rely.

It is to do what we must to weather the tempest around us and to strengthen the economy to face future storms that will inevitably arise.

That is what our balanced approach is all about – an approach we knew when we came into office was long overdue.

We understood, then, that the economic and fiscal problems facing the country were not superficial; they were structural.

And we realized that there were many interrelated problems to address, that a simple solution focused on a single problem alone would not work. That tinkering would not do; that deep reform was required.

For that reason, we put in place a long-term plan.

Its goal? To provide Canadians with what had been absent for too long: the architecture of a modern, productive economy, one of growth and jobs.

In short, to forge a new alliance between the strength of our economy and the security of our society.

The steps to reach that goal were clear.

First, we knew we had to get interest rates down – because they were standing in the way of growth and the creation of jobs. And to get interest rates down, we knew we had to restore sound financial management and move decisively towards a balanced budget.

Second, we knew we had to reduce our debt-to-GDP ratio – because interest payments on the debt were chewing up precious resources the country needed to build and secure the future. And we recognized that this meant not only getting the debt down, but improving the productivity of the economy – getting growth up.

Third, we recognized that spending cuts would be necessary in the short term, and that these would be difficult. But we knew as well that, once our financial health was restored, focused investment in the key social and economic priorities of Canadians would be essential if we were to reach our overarching goal – a Canada of opportunity, one where all our citizens could be confident of their future, able to enhance their own prospects and those of their families.

Finally, we also knew that taxes had to be brought down – because Canadians simply deserved to keep more of the income they earn through their own hard work.

Through all of this, Mr. Chairman, we knew that the nature of government itself had to change. Not only its budget, but its focus. Not simply its size, but its direction.

That the days of trying to be everything to everyone at any cost were over.

That the need to have clear priorities, to realize where government could make a difference – and where it could not – was essential.

That the pursuit of frugality had to become a defining feature of everything that we do – that partnership in today's modern economy was not a sign of weakness, but of strength.

That approach – one we have been pursuing for five years – has worked. As the Prime Minister has said, it will not be abandoned. Indeed, it will be bolstered.

Let me emphasize that we have not been doing any of this because it satisfies some textbook definition of good economic fundamentals.

We are doing this because it speaks to the fundamentals that really count for Canadians.

A higher standard of living – for the many, not the few. And a higher quality of life – in communities from coast to coast to coast in this country.

Putting Our Performance and Our Prospects in Perspective

Now, Mr. Chairman, when we were talking about our plan and our prescription several years ago, it was proposition. But today, we are well beyond that. Today, we can talk about proof, about performance.

Consider the progress the country has made.

Five years ago, the federal deficit stood at $42 billion and rising.

We said we would bring it down steadily each and every year. And we did – not only meeting, but beating every target we set.

Last February, we said we would balance the budget in the 1997-98 fiscal year that was then coming to an end.

And we have.

Indeed, as outlined in the *Annual Financial Report* being released today, we have done better than that.

I am pleased to announce that, for the first time in more than a generation, the Government of Canada recorded a surplus – $3.5 billion.

That money has been applied directly to the debt.

This marks the first time in 28 years that Canada has actually paid down the debt.

This is a historic milestone.

And it is an achievement that belongs not to government but to Canadians themselves.

Let me emphasize a further point as well. The accounting method we in Canada use to calculate our balance sheet is considered among the most rigorous in the world, for it includes all the liabilities government incurs in any given year. This is the measure on which I have just reported.

Most other major industrial economies use another measure – financial requirements – which includes only the borrowings that government makes in the financial market.

According to this measure, Canada has in fact recorded a financial surplus for two years in a row – the only G-7 country to do so.

This has allowed us to lower the amount of debt we owe to financial markets. As such, we paid down $9.6 billion of market debt last fiscal year. And we will likely be able to report a significant further paydown at the end of the current fiscal year as well.

Mr. Chairman, this speaks to progress at the federal level. However, the provinces have made very significant progress as well. In 1992-93, the federal and provincial governments, taken together, recorded a $66 billion deficit. That has now been entirely erased.

Beyond financial progress, consider as well the economic progress the country has made over the past four years. This, too, serves as an essential starting point for our future course of action, for the choices we must make in this period of economic uncertainty.

In the fall of 1993, the unemployment rate was 11.4 per cent. Today, while still too high, it is at 8.3 per cent, its lowest point in eight years, a track record of improvement exceeded only by the U.K. among the G-7 nations. Over 1.3 million jobs have been created during this period – 636,000 since the beginning of last year.

Interest rates have been brought down substantially. The spread between Canadian and U.S. rates is significantly less than it was only three years ago.

As importantly, interest rates on long-term government bonds – which have a key influence on mortgage rates and on what business pays on the money they borrow to invest, thereby creating jobs – are at their lowest level in three decades.

Inflation is under firm control and will remain so. Indeed, Canada now enjoys a solid reputation as a low inflation country.

Now, as we have said, no one is immune from the developments in Asia, Russia and elsewhere. Clearly, they are having an impact on our economic prospects, as they are on those of others.

For instance, through to the end of the first quarter of this year, the economy enjoyed seven quarters of robust growth, averaging 3.7 per cent. However, over the past few months, performance has been disappointing.

Our exports to Asia are down sharply – by more than 30 per cent in the first seven months of 1998, compared to the same period one year ago, although this has been offset by strong growth in our trade with the United States. Economic growth has slowed in many parts of the country. Western Canada, in particular British Columbia, is being hit hard.

As a result, private sector forecasts for overall Canadian growth are down for this year and next.

And the fact is our currency has been under pressure.

But consider not only where our currency would be, but where the country might be today if we had not acted five years ago.

Consider what the impact on Canada of today's global uncertainty would be if we were still running massive deficits, if our reliance on foreign lenders was still increasing, if our interest rates were sky high and rising.

We would be talking about more painful cuts, not new investments.

We would be talking about how large the debt would grow, not about bringing it down.

And we would not be talking about cutting taxes.

No one should downplay the danger posed by the current global environment. But the fact remains: despite recent developments, the major international institutions – the IMF and the Organization for Economic Co-operation and Development, the OECD – expect Canada's economic and employment growth this year to be among the best of the major industrial nations.

And we will, as we said in February, balance the budget this year, and we will balance the budget next year.

And let us be very clear on the issue of our currency.

Yes, these have been troublesome times for the Canadian dollar.

But it is the structural problems that were allowed to fester over a period of 25 years that have caused its long-term decline – problems that Canadians have gone a long way to address.

The markets have an image of the Canada of yesterday, not the Canada of today. The perception is wrong. The filter is false. Consider the following:

- For two decades, Canadian inflation was generally above U.S. inflation; for the last five years, it has been consistently lower.
- Throughout the 1970s, 1980s and early 1990s, government deficits were much larger in Canada than the U.S.; Canada now has a surplus.
- Our debt-to-GDP ratio was rising for more than 20 years; now it is falling.
- For many years, Canadian productivity growth lagged behind that in the U.S.; last year, it was much higher in Canada – 2.8 per cent here versus 1.7 per cent there.
- In 1980, exports of resource-based commodities accounted for 60 per cent of total exports; today, the share is down to 35 per cent.
- Exports of machinery, equipment and automotive products have accounted for a larger share of our exports than have commodities every year since 1992.
- The high-tech sector in Canada has posted a level of growth in jobs and output throughout this decade that is twice the rate of the rest of the economy.

Mr. Chairman, this reality is Canada: more diversified, more sophisticated and anchored in a much sounder financial footing than it has been for decades.

The Road Forward: Our Balanced Approach

That being said, we still have a long way to go.

Let me elaborate on how we will meet the challenges still before us.

Reducing the Debt Burden

Despite the headway we have made in balancing the books, it is clear that a quarter century of deficits has left us with a debt burden that is still far too high.

The best measure of this burden is to look at the debt in relation to the size of the economy that supports it. This is the debt-to-GDP ratio – what we owe in relation to what we produce. The lower the ratio, the more manageable the debt.

For 20 years, that ratio was rising relentlessly. However, in 1996-97, as a result of a growing economy and the restraint measures we introduced, it fell meaningfully for the very first time.

Last year, it fell even further – by 3.3 percentage points, from 71.1 per cent to 67.8 per cent.

This represents the largest single year improvement since 1956-57.

It also represents the first consecutive back-to-back reduction in the debt-to-GDP ratio since the early 1970s.

However, we still have a long way to go. Our debt-to-GDP ratio is the second highest in the G-7. Too much of every tax dollar goes to pay interest on the debt rather than to purposes that are productive – for the country and for Canadians.

Looking ahead, our commitment is to keep the debt-to-GDP ratio falling permanently.

The Debt Repayment Plan we put in place in the last budget will ensure that happens.

First, we will, as we always have, present two-year fiscal plans based on prudent economic assumptions. This year, the budget will be balanced. And we will balance the budget next year. This will mean three consecutive years of budgets that are balanced or better.

We will not forego the gains we have made. Our commitment to continued financial progress is rock solid.

Second, we will build into our plans, as before, a buffer, a $3 billion Contingency Reserve.

And third, if the Contingency Reserve is not needed, it will go directly to paying down the debt.

Based on a realistic assumption of between 3.5- and 4-per-cent average nominal income growth and budgets that are in balance, in five years, the debt-to-GDP ratio would be down to around 55 per cent.

This would represent real progress. But we cannot stop there, and we won't.

The fact is, the federal government has a responsibility to all Canadians to continue to make progress on reducing its debt burden.

Let me give you one example. The interest rates the federal government pays on its debt determine, in large measure, the interest rates provinces pay on theirs.

As our financial recovery continues, they will benefit. Were we to stall or fall back, they would pay the price too.

Moreover, the federal debt-to-GDP ratio stood at 68 per cent last year – the provincial debt burden stood at only 26 per cent.

Last year, we paid 27 cents out of every revenue dollar for interest on the debt. The provinces paid only 13 cents.

The provinces may want to take this into account in making demands on the federal purse.

Investing in the Highest Priorities of Canadians

Mr. Chairman, let me now turn to the second element of our balanced plan – investment in the highest priorities of Canadians.

It is critical to restate the fundamental point that the role of government does not begin and end with taking care of the books. Its purpose is to respond to the needs of its people.

Its role must be to help Canadians adjust to change and prepare for the future.

There are crucial needs that market forces, if left alone, will simply not meet.

Government has a clear responsibility to act – for example, on protecting the environment, on advancing research and development, in fostering the creation of jobs, and in helping to lead the fight against child poverty.

We can never lose sight of the fact that a strong economy and a secure society are not separate, distinct ends. A strong economy is necessary to support a secure society. But so, too, a secure society provides strength to the economy.

It gives Canadians the confidence they need to reach as high as their talents and ambitions can take them.

A secure society widens the mainstream. It expands opportunity. It allows each individual to act upon and realize their own potential.

Clearly, health care is at the top of the list for Canadians in every region of the country.

It is at the core of how we define ourselves as a national community – one of fairness and compassion.

That is why, as the Prime Minister has said, "the government will invest more of our resources in the years ahead to reinforce our public health care system".

The principles contained in the *Canada Health Act* – of access to care based on need, not income – are, for most Canadians, not simply sections of a piece of legislation. They virtually constitute a charter of rights.

Yet today, Canadians are profoundly concerned that their health system is declining. That quality care will not be there when they or their loved ones need it. That the worst may, in fact, lie down the road. This concern must be addressed. Let me tell you, no one can take on the challenges of the new economy while preoccupied with the availability of basic health care. No parent of an ill child. And no child of an ageing parent.

We welcome the assurances of Canada's premiers that any additional federal funding provided to the provinces for health care will indeed be used for that purpose.

We share strongly their desire – and the desire of all Canadians – to have confidence restored in the health care system, and we want to work in partnership with the provinces to secure that confidence.

Reducing Taxes

Let me turn now to the third part of our plan – reducing taxes for Canadians.

With the budget in balance, Canadians have a right – and we have a responsibility – to ensure that more money is left in their pockets. This is one key to raising the standard of living and increasing disposable incomes for all Canadian families.

When the deficit reduction challenge had yet to be fully met, we were not able to move forward with broad tax relief. We simply could not afford it.

However, as a result of our better-than-expected financial progress, we were able to provide targeted tax relief where the need was greatest – for students, for charities, for persons with disabilities, and for the children of working parents with low incomes.

Then, last February, for the first time, with budget balance secure, we were able to not only offer even more significant targeted tax assistance, but to also move on to broader tax measures, focused, as a matter of fairness, on low- and middle-income Canadians. These were only first steps, but they were important – affecting 90 per cent of all taxpayers. In total, the tax measures in our last budget will provide $7 billion of relief over three years.

We said in the last budget that we would build upon these measures as we can, and that we would do so in a measured and responsible way. That is what we will do.

Limited Resources and Responsible Choices

Mr. Chairman, at this point, it is essential that we step back and consider the economic context in which we must make our policy choices in the coming months.

In a very short time, the world has become an inhospitable place – one of great danger and considerable risk.

We are in a situation that calls for great care and caution.

We must be realistic about the resources at our disposal.

Today, some seem to believe we have mountains of money to spend. We don't.

They seem to feel we are now in a position where we don't have to continue to make hard choices. We do.

Look at what has happened to the average forecast of economic growth by private sector experts since only the beginning of this year.

In January, they were estimating nominal income growth of 4.7 per cent for 1998. That has now been revised downward to 3 per cent.

And for 1999, they were projecting 4.9-per-cent nominal income growth. That, too, is down significantly – to 3.5 per cent.

What do these revisions mean for the size of the dividend as projected by the private sector?

The answer is they would knock over $5 billion out of government revenues in 1999-2000.

Only a few months ago, these forecasters were estimating a 1999-2000 surplus, before any new budget actions, of around $10 billion. The recent downward revisions would lower their estimates to around $5 billion – or $2 billion once the $3 billion Contingency Reserve is subtracted.

Mr. Chairman, at the time of our last budget, many criticized us for being too prudent, too cautious.

Well, in the face of today's global turmoil, I doubt if there are many people who would still subscribe to that notion.

The dramatic downward revision in private sector forecasts illustrates more clearly than anything why this government must stick to its careful approach to budget planning, why we simply cannot afford the risks associated with changing planning assumptions so drastically, month by month.

This is not academic, some arcane point from economic theory.

Consider the result if we had followed the advice of some not long ago to take $9 billion to $10 billion worth of tax action – action they claimed we could afford. We would now be heading for a substantial deficit.

Further, while we have noted that the downward revision to economic forecasts could lower the private sector estimate of the dividend to $2 billion – when the $3 billion Contingency Reserve is taken out – with all the uncertainty that exists worldwide, it may well be that further downward revisions will occur.

In any event, it is clear the dividend in the next two years will be modest, much less than would be required to provide sufficient funding for the size of initiatives – on taxes and spending – that many are calling for. And clearly, careful choice in allocating that dividend will be required.

Now, some, of course, would throw caution to the wind, saying, well, maybe we will have the money. Maybe the dividend will be larger than we think. That it's worth the risk to cross our fingers, and pray that things will turn out that way. In other words, it's time now, acceptable now, to set aside the careful and cautious approach we have been following.

Well in my opinion, that is the financial equivalent of reckless driving – you may not have an accident but, if you do, you not only hurt yourself, you can sideswipe a lot of innocent people.

The very reason we have met our targets, the very reason we are now able to say that, despite the global economic crisis, we are still on track not only to balance the books but to have a dividend – all of this is anchored in the caution we have applied from the very beginning.

Those who propose that we can comfortably contemplate putting aside caution – especially now – are either shooting from the hip or suggesting that we should shoot ourselves in the foot.

Mr. Chairman, let me give you an example of what I mean.

Despite recent events, some are saying we should implement a major personal income tax cut, for example, of an average of $600 annually per taxpayer.

That would cost about $9.0 billion per year.

Some are demanding that employment insurance premiums be reduced to the so-called 'break-even' level.

That could cost more than $6 billion per year.

The provinces are asking, despite the rise in tax points, that cash transfers be increased.

Their proposal would cost about $6 billion per year.

And still others are saying we should mount a larger attack on the debt.

That could cost, for example, another $3 billion per year.

Now, add all that up.

The total bill is $24 billion – each and every year. And that is a long way from a complete inventory of the demands that are being made.

We have pointed to the downward revision in private sector forecasts and the impact slower economic growth is likely to have on our revenues and therefore available financial resources.

Adopting all the proposals we have just outlined would very clearly put the country back into a situation of serious, chronic deficits.

Not only that. Apart from debt reduction, adopting any one of these proposals in their entirety would put us in financial difficulty.

That, quite simply, is the very worst thing we could do.

Safeguarding our financial health at home is the *sine qua non* of riding out the global storm we are now in.

Turbulence abroad mandates vigilance here at home.

Make no mistake. We will do what we can. But we will only do what we can afford.

It is in this context that the discussion on the reduction of employment insurance premiums must be engaged. As we noted earlier, many are demanding the premiums be brought down dramatically. This flows from the procedure that has been in place for some time to set premium rates.

Under this procedure, the Employment Insurance Commission is mandated to set the rate so that premiums paid in will balance the costs of benefits paid out over the course of an economic cycle. In order to monitor the status of this program, there is a notional Employment Insurance Account that records revenues and expenses each year and shows the cumulative balance between them over time.

Mr. Chairman, what has caused a great deal of misunderstanding is that, while there is a notional Employment Insurance Account, it is an accounting mechanism only. Since 1986 – at the insistence of the then-Auditor General – the Employment Insurance Program has been fully integrated into the overall finances of the federal government.

In other words, as a result of decisions taken by those who came before us, EI premiums paid are entered in the country's books just like any other source of revenue – as are benefits paid out, just like with any other program. Even prior to 1986 – indeed from its inception in 1940 – the EI Program was specifically designed in such a way so that no actual funds enter into a special account.

Some are saying we are breaking new ground in continuing to have EI premiums cover more than the cost of the EI Program itself. We are not. This is not new. Far from it.

Throughout the history of the EI Program, the cumulative balance between premiums and expenditures has swung between deficit and surplus. In fact, there has been a deficit at the end of 10 of the last 17 years, and the government assumed

responsibility for it. In years of deficit in the EI Account, the government covered the excess of costs over premiums – and, as a result, the government's overall deficit was pushed up. On the other hand, in years of surplus in the EI Account, the government's overall fiscal balance improved as a result.

It is true that the surplus is much larger now than ever before; however, it is important to note that other political parties have either explicitly or implicitly advocated over the past five years – that the resources generated by the EI Program be part of our successful effort to balance the nation's books.

Therefore, Mr. Chairman, what is the fundamental issue before us? Every year since we have taken office, we have reduced EI premiums. Employees and employers are saving $2.6 billion alone this year as a result. However, some say that it is now time to bring the EI premium rate down even more sharply.

Where the rubber hits the road is that this could cost more than $6 billion annually and could drive the country back into deficit.

Moreover, with such a large reduction, clearly there would be no room for personal income tax cuts. No possibility of any needed investment in health care or anything else.

The issue isn't simply how much do we cut EI premiums, it's do we ignore the turmoil enveloping the world economy? It's do we abandon the balanced approach that has served the country so well over the last five years?

It is at this point that the debate is truly joined. It is here that some very straight talk is required.

Let there be no doubt. We wish we could reduce EI premiums significantly. We wish we could bring personal income taxes down dramatically. We wish we could devote large-scale new resources to health. We wish we could invest significantly more in the environment, in job creation, in research and development, and in addressing child poverty.

We wish we could do all of that – and more. But we can't. We simply don't have the money now.

The world economy is going through a period of major difficulty and disruption.

As a government, we have many responsibilities, but today there is one that is most immediate. And that is to use every means at our disposal to protect this nation and its people from the global troubles that surround us.

This, we will do.

The challenge today is not to concoct some wish list as if money was no object and as if the world were a tranquil place.

The challenge we face is to take the limited resources that we have and make responsible choices in a world of great turmoil.

Therefore, there can only be very limited action, if any, in bringing down the EI rate for 1999, because we are determined to protect the finances of the nation, continue to foster jobs and growth and, as resources permit, invest in medicare and the reduction of personal income taxes for Canadians.

Mr. Chairman, we have stated today what our priorities and our choices are. Others, of course, will have different views. And this committee is a very important forum for the debate that is now underway.

When people make the case for a drastic, immediate EI rate cut, ask them if we should put the financial health of the nation at risk at a time of worldwide economic turmoil.

Ask them if they place less importance on investment in health, or on reducing personal income taxes for Canadians.

When people ask for additional spending, ask them where we are to get the money. And when others say that the way to pay for a large reduction in taxes is to slash spending, ask them to tell you specifically what they would cut – when, in relation to the size of the economy, government spending on programs today is already at its lowest level since demobilization after World War II.

Conclusion

Mr. Chairman, today we have outlined our plan for the future. Although many of the measures of which we have spoken relate to the short term, they are also very much part of a longer-term agenda which must be the focus of all our efforts going forward. The goal of that effort is to raise the standard of living and the quality of life for all Canadians. And the only way to get there is to continue, year after year, to put in place the foundation for a stronger, more productive economy.

Despite the problems of the day, we must never again allow short-term preoccupations to blind us to the long-term needs of the nation. The fact is, that's what governments have done all too often, neglecting the need for a consistent, long-term economic strategy – and it is Canadians who paid the price.

Employment policies were adopted that actually discouraged people from working. Intrusive regulation and micromanagement of the economy became a growth industry. In good years, there were big deficits. In bad years, there were bigger deficits. Through it all, trying to square a circle that could ultimately not be squared, governments adopted rosy economic outlooks – almost always wrong.

Governments focused on fine tuning economic performance to smooth out bumps in the road. What they didn't do was look far enough ahead to see that the road was in fact a dead end.

The result? Soaring taxes. Double digit deficits. Triple digit debt.

Our plan has been dedicated to addressing each of those root causes one by one.

Progress has been made. Is it significant? Clearly, yes. Is it good enough? Clearly, no.

We must press on – and press on we will.

Mr. Chairman, we began today's discussion by addressing the economic turmoil that is gripping much of the globe – and whose consequences are today reaching our shores.

We have made it clear that, while concern is warranted, Canada is well positioned – something it would not have been possible to say only four years ago.

But it must also be understood, much as all of us would wish it otherwise, that today's period of difficulty and uncertainty is neither the first, nor the last, our country will face. As globalization widens and deepens – as it surely will – other disruptions will occur. That is simply a fact of life.

However, this does not mean our only response can be a fatalistic shrug. Indeed, it means the opposite.

Let me quote from our February budget, brought down at a time when the clouds were only beginning to gather on the horizon:

"Globalization and technological change are a reality. They are not a religion. They are a fact. They are not a faith.

We commit a very serious mistake if we ever come to believe that the global economy abroad means there is no role, no responsibility on the part of government to provide opportunity and security at home...."

Mr. Chairman, what does that mean for the future?

As the Prime Minister has said, first, it means continued sound financial management. And second, it means responsible and focused economic and social investment. Both of which will work together, reinforcing each other, to build a strong economy and a secure society – one that will provide a higher standard of living and quality of life for all.

In short, it means exercising the kind of economic leadership that will help shield us when times are bad – and propel us forward when times are good. That is our purpose and our course.

There can be no doubt that recent economic developments are indeed disturbing.

After spending years of effort and sacrifice cleaning up the mess inherited from the past, Canadians are now confronted with new challenges, ones this time not of our own making, but originating beyond our shores.

We face a choice, a test.

Do we look to the long-term needs of the nation or do we pull back, seeking refuge in quick fixes, in desperate measures, in short cuts to nowhere?

Do we stick to, and strengthen, our balanced plan of sound fiscal management, of responsible tax policy, of careful and focused investment? Or do we fall prey to the temptation to tilt, to take undue risks with the financial health of our country?

Mr. Chairman, today we have provided our answers to those questions.

The plan we have pursued, and the principles which underpin it, have served our country well.

Ours is not a plan only for good times.

It is a plan not to be implemented – or judged – on the basis of one budget, one year – or one mandate. It is a plan of solid and sure steps, each building on the last, of careful construction of the new framework for the new economy of the new century.

Canada is no longer the high deficit, high inflation, commodity-dependent, low productivity country of the past – but is in fact becoming a leader, a country that can set our own standards of excellence because we have already met the standards others have set.

The most important debate in this country is no longer only that between left and right.

It is between those who believe we should settle for second best – and those who know our country has the potential to be the very best.

It is between those who believe our future will be but a pale imitation of the past – and those who see our story as one whose greatest chapters have yet to be written.

It is between those who believe the role of government is to simply stand aside and do nothing – and those who know that today, more than ever, government has a responsibility to stand with, to stand alongside Canadians.

We believe in a strong and secure Canada. Canadians are building that country today.

Make no mistake. While the winds may buffet us, they will not drive us off course. We will succeed.

Annexes

1

Canada's Economic Developments and Prospects

Highlights

"The international economy has entered a period of turmoil not seen for a very long time."

"... no one is immune from the developments in Asia, Russia and elsewhere."

"As a result, private sector forecasts for overall Canadian growth are down for this year and next."

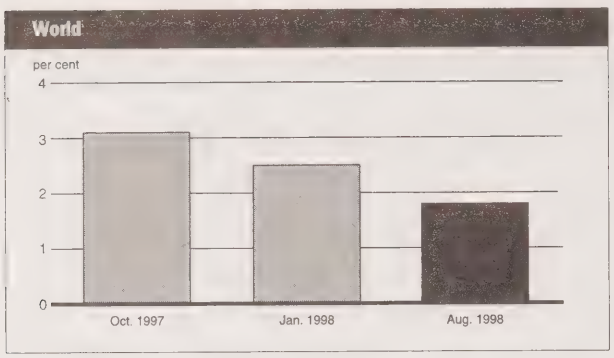
"... despite recent developments, the major international institutions ... expect Canada's economic and employment growth this year to be among the best of the major industrial nations."

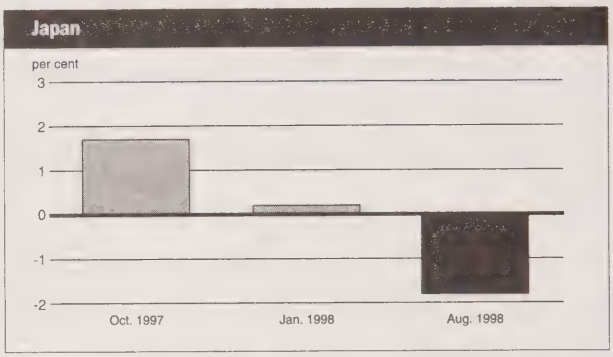
The Honourable Paul Martin
Minister of Finance

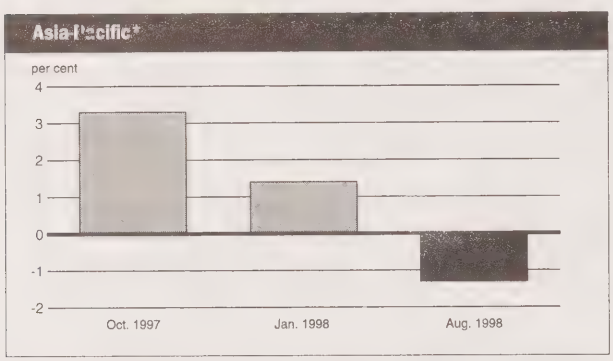
- *The outlook for world economic growth in 1998 has been revised down steadily over the past year, owing mainly to the financial crisis in Asia.*
- *This crisis and the accompanying weakness in global commodity prices have adversely affected Canada's trade sector, particularly in British Columbia. Better-than-expected economic performance in the U.S. in late 1997 and early 1998 has partly offset this weakness.*
- *Weak commodity prices have negatively affected Canada's terms of trade and have dampened gross domestic product (GDP) inflation, as well as nominal income, which is an important determinant of the government's revenue base.*
- *Real output growth has also moderated recently, although some of this moderation reflects the impact of strikes and other temporary factors.*
- *Canada's success in eliminating the deficit and in keeping inflation low has helped keep interest rates at historically low levels despite recent increases.*
- *As a result of world economic and financial turbulence, private sector forecasters expect the expansion to slow substantially in 1998 and 1999.*
- *Nevertheless, the International Monetary Fund (IMF) still expects Canada to compare favourably to the rest of the Group of Seven (G-7) countries in real GDP growth in 1998 and 1999 and to be far in the lead in job creation.*

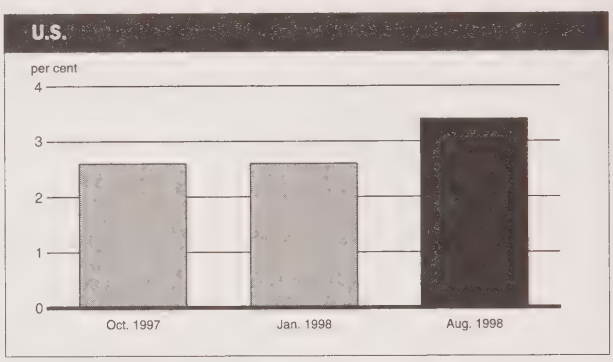
Forecasts for world growth have been marked down since the budget.

Real GDP growth forecast for 1998







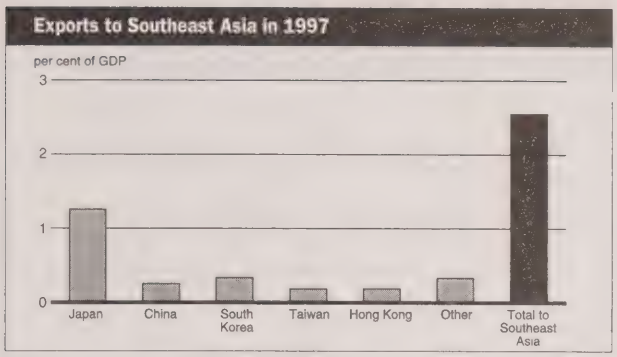


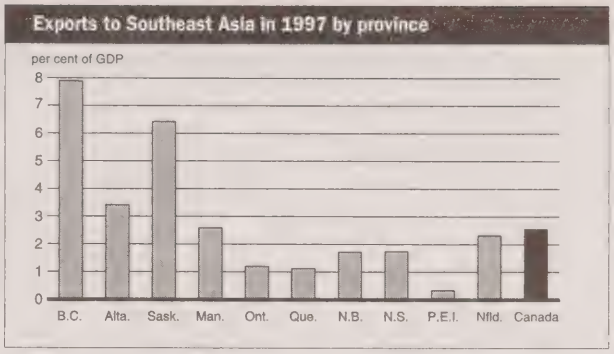
*Japan, China, Hong Kong, Indonesia, Malaysia, New Zealand, Australia, Singapore, South Korea, Taiwan, Pakistan, Philippines, Sri Lanka, Vietnam and Thailand.

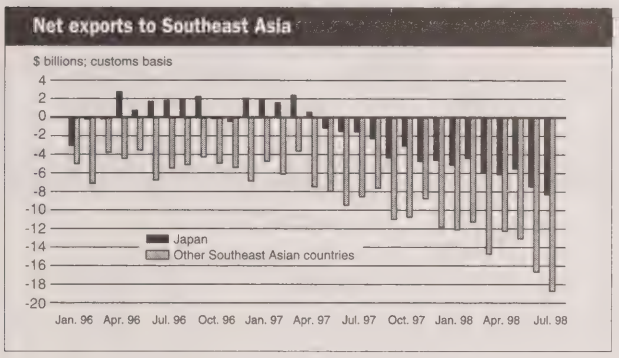
Source: Consensus Economics.

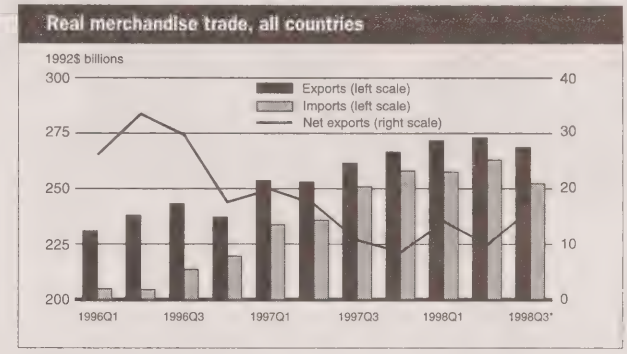
- As a result of the financial crisis in many Asian economies and the recession underway in Japan, the outlook for world economic growth in 1998 has been revised down steadily over the past year.
  - The economic and political crisis in Russia and the possible contagion effect on Latin American countries represent an additional source of risk to the global outlook.
- The impact on Canada of the situation in Asia has been partly offset, however, by a better-than-expected economic performance in the U.S. in late 1997 and early 1998. This has led forecasters to revise up their U.S. growth projections for 1998 as a whole.

Developments in Asia have had a negative impact on Canada's trade performance.





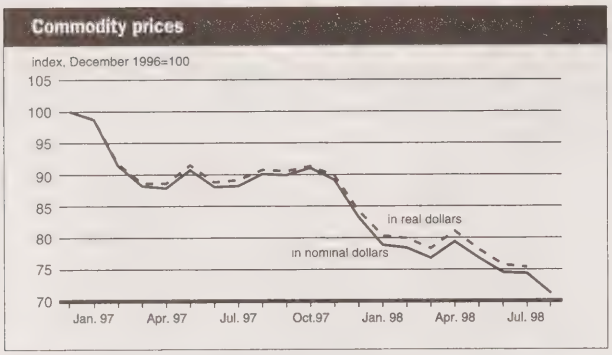




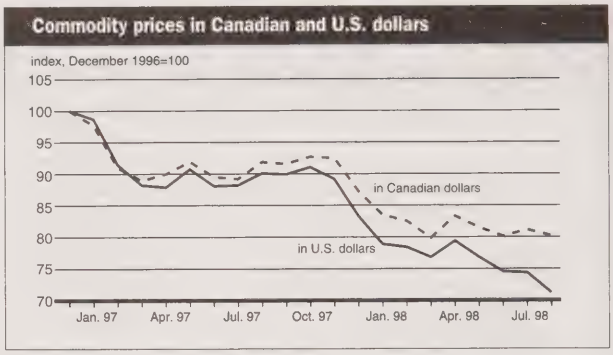
*Based on July data.

- Canada's trade with Asia has been adversely affected by weaker activity in Asia and the steep depreciation of many Asian currencies.
- Canada's western provinces, especially British Columbia, have been the hardest hit as they rely heavily on trade with Asia.
- That said, exports to Southeast Asia – which includes many of the Asian countries involved in the crisis – account for only about 2½ per cent of Canada's GDP; half of this is accounted for by Japan. In comparison, exports to the U.S. amount to nearly 30 per cent of Canada's GDP.
- Given the high concentration of Canada's foreign trade with the U.S., our trade and economic performance has been somewhat insulated from the adverse effects of the "Asian flu", at least in real (i.e. inflation-adjusted) terms.
  - Indeed, total real net exports have improved so far in 1998 – despite the onset of the Asian crisis – partly as a result of continued strong growth in the U.S. which has supported exports to that country.

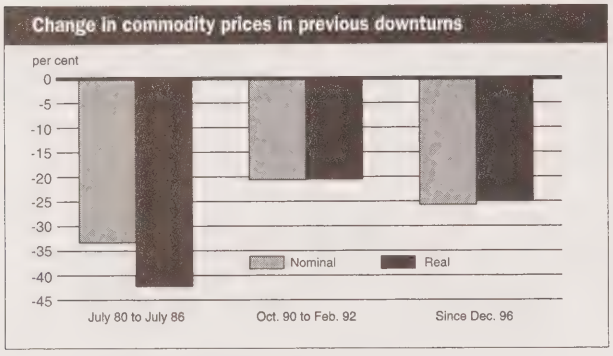
Commodity prices have also been adversely affected.



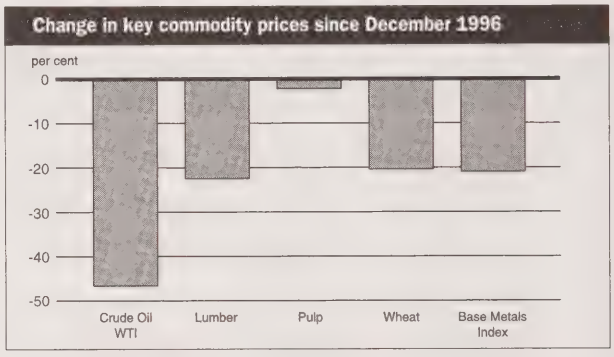
Source: Department of Finance Commodity Price Index, in U.S. dollars.



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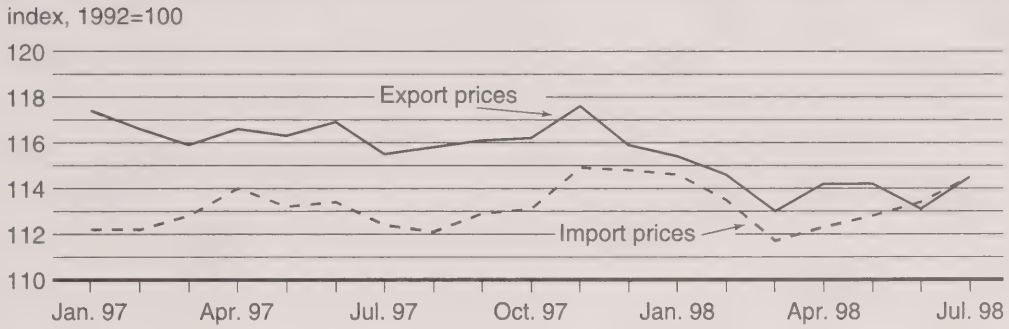


Source: U.S. Commodity Research Bureau and Walden's Fiber & Board Report, in U.S. dollars.

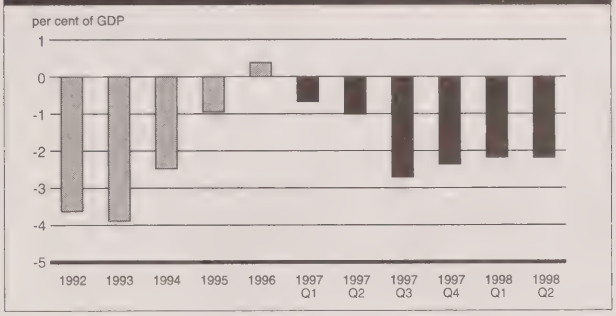
- The build-up of large excess supplies of commodities, due in part to the turmoil in Asian economies, has put downward pressure on world commodity prices since late 1996.
- The U.S. dollar prices of resource-based commodities produced by Canada have fallen about 28 per cent since their peak in December 1996.
- However, the depreciating Canadian dollar has helped to buffer the impact of lower commodity prices on commodity producers' Canadian dollar cash flow. As a result, in Canadian dollars, commodity prices haven fallen by less (about 20 per cent) since December 1996.
- In both nominal and real terms, the current decline in commodity prices is similar to the one experienced in the early 1990s, but much less severe than the decline in the first half of the 1980s.
  - However, the current downturn is more widespread with prices for crude oil, lumber, wheat and base metals all experiencing sharp declines. Moreover, commodity prices have dropped more quickly than in previous major downturns.

Lower commodity prices have translated into lower export prices.

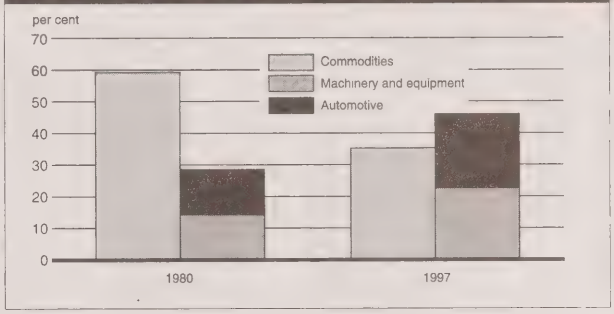
Export and import prices



Current account balance



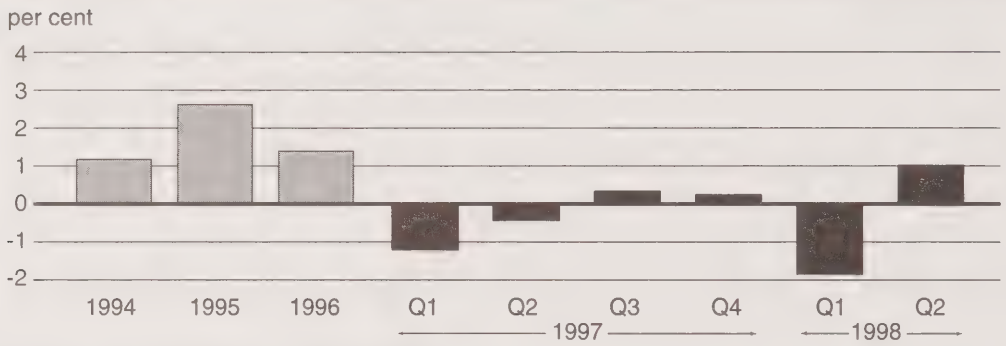
Shares of selected products in Canada's merchandise exports



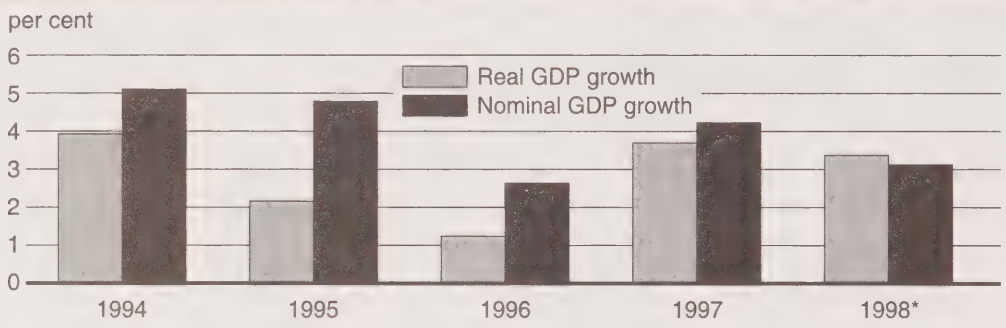
- The large decline in commodity prices has led to a decline in the price of Canada's exports relative to the price of our imports – a deterioration in the terms of trade. This has contributed to a rise in the current account deficit. Nevertheless, as a share of GDP, the current account deficit remains much smaller than in the early 1990s.
  - Less favourable prices of exports relative to imports have the potential to dampen growth in incomes and profits, particularly in the commodities-producing sector.
- While resource-based commodities are still important to the Canadian trade sector, they are much less so than in the past. The share of commodities in Canada's merchandise exports declined from nearly 60 per cent in 1980 to 35 per cent in 1997, while the share of machinery and equipment and automotive exports increased from about 28 per cent to more than 45 per cent over the same period.

The overall price of production and nominal GDP growth are also lower.

GDP inflation



Real and nominal GDP growth

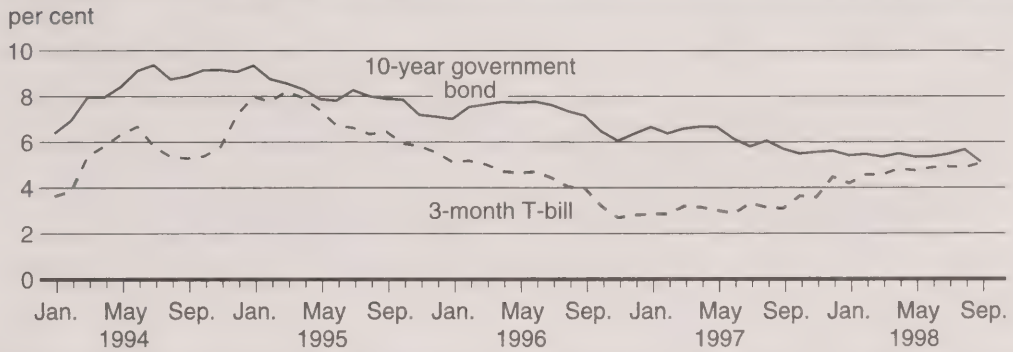


* Growth of real GDP in 1998 is the year-over-year growth for the first two quarters of 1998.

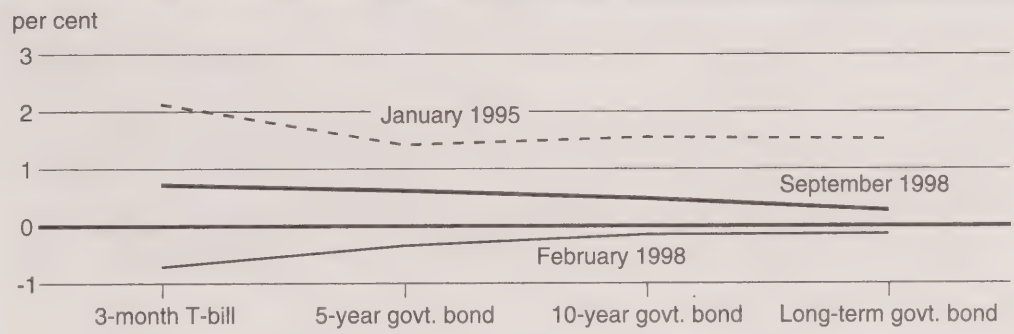
- Less favourable prices of exports have put downward pressure on the aggregate price of Canada's production. For the first time in 35 years, the quarterly growth rate in the aggregate price for Canada's production (GDP inflation) was negative in three of the last six quarters. Moreover, by the second quarter of 1998, this price was 0.5 per cent below its level at the end of 1996.
- Real economic activity expanded at a healthy pace through 1997, with real GDP rising by 3.7 per cent – the second strongest performance seen in the 1990s. But with the slowing growth in the aggregate price of production through 1997, nominal GDP did not increase much more than real GDP in 1997.
- Nominal GDP growth is likely to slow substantially in 1998 compared to 1997, owing to slower growth in both real GDP and GDP price deflator.
  - Nominal GDP growth provides a good approximation for growth in the government's tax base, and thus growth in revenue collections.

But interest rates remain low by historical standards.

Canadian interest rates



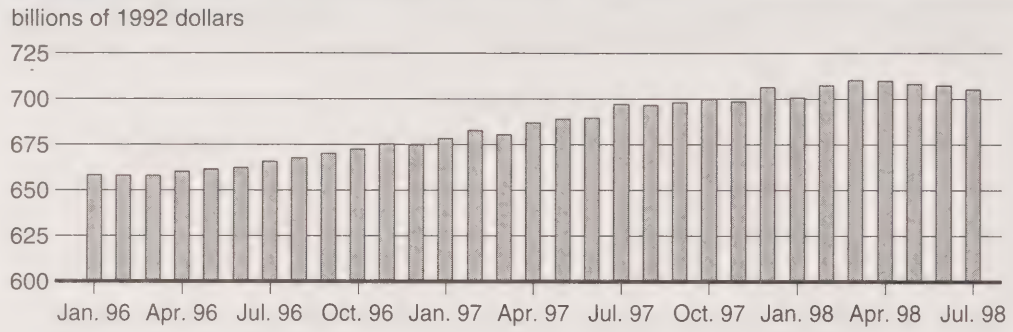
Canada-U.S. spreads along the yield curve



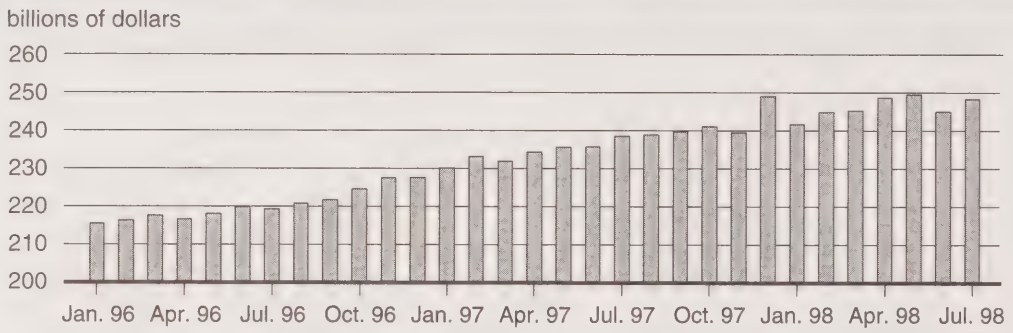
- The implementation of sound economic and fiscal policies over the last four years has helped to reduce interest rates.
- Despite recent increases, interest rates are still much lower than their peak levels reached early in 1995.
  - In particular, at less than 5 per cent at the end of September, both short- and long-term interest rates remain nearly half their average levels over the last two decades.
  - Although Canadian interest rates have moved slightly above U.S. rates, spreads remain well below where they were in 1995 and below historical averages.

Lower interest rates will help support domestic demand.

Real GDP



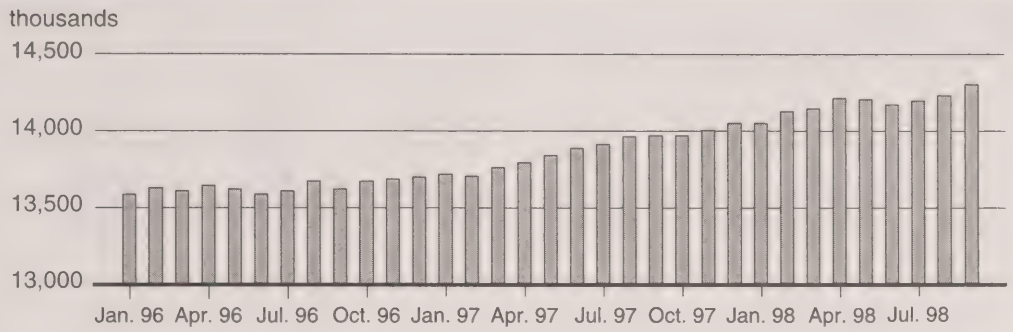
Retail sales



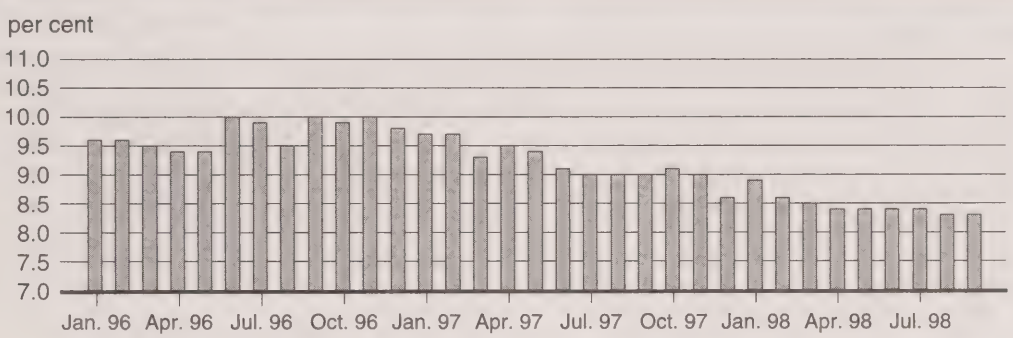
- The Canadian economy expanded at a strong pace through 1997 and into the first quarter of 1998. But B.C. has been hard hit since late 1997 by developments in Asia and in commodities markets.
- Growth moderated to 1.8 per cent (annual rate) in the second quarter and showed some softness at the beginning of the third quarter. However, strikes and other temporary factors have distorted recent data, thereby complicating the assessment of the underlying trend of growth in recent months.
  - For example, the General Motors (GM) strike in the U.S. caused most Canadian GM operations to cease due to parts shortages, forcing many domestic GM suppliers to reduce output as well. The fall in automobile industry output in June and July reduced real GDP growth by 0.3 percentage point in the second quarter and by 0.6 percentage point so far in the third quarter. However, with the end of the strike early in the third quarter, much of this lost activity is likely to be recovered over the rest of the year.
- Nevertheless, a solid rise in retail sales in July augurs well for continued growth in domestic demand in the third quarter.

Job creation has been solid.

Employment



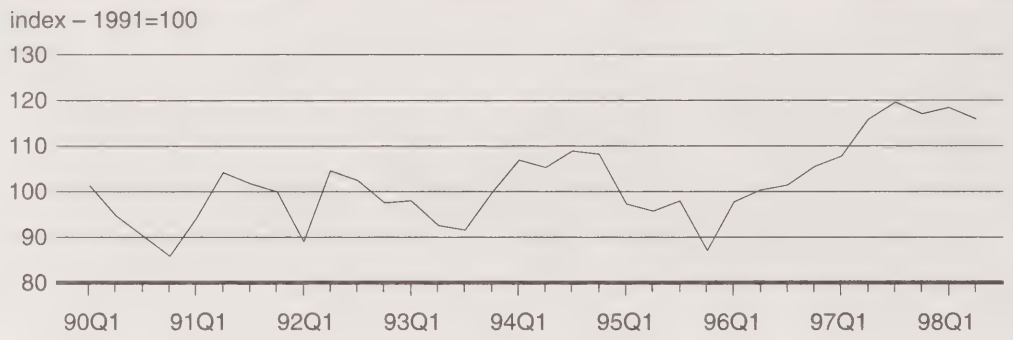
Unemployment rate



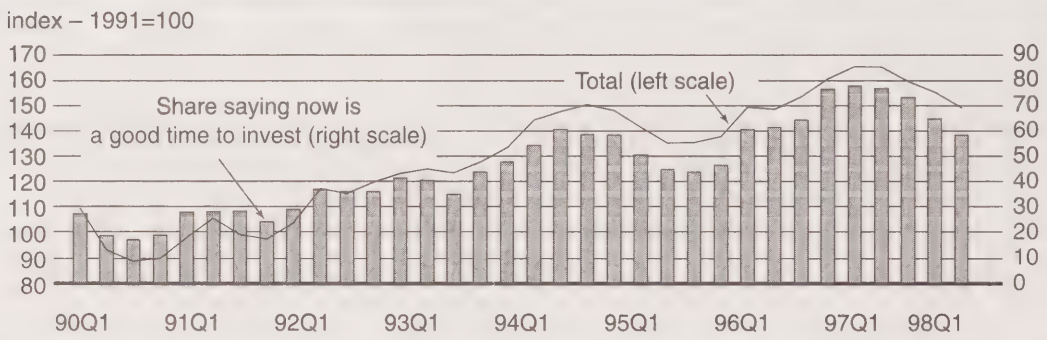
- Overall labour market conditions have been healthy – 264,000 jobs have been created over the first nine months of this year, bringing the total number of jobs created to 636,000 since the end of 1996 and to over 1.3 million since the fall of 1993.
- This solid employment growth has driven down the unemployment rate from nearly 10 per cent at the end of 1996 to 8.3 per cent in September 1998 – its lowest level in eight years.

Solid confidence boosted domestic demand.

Consumer confidence



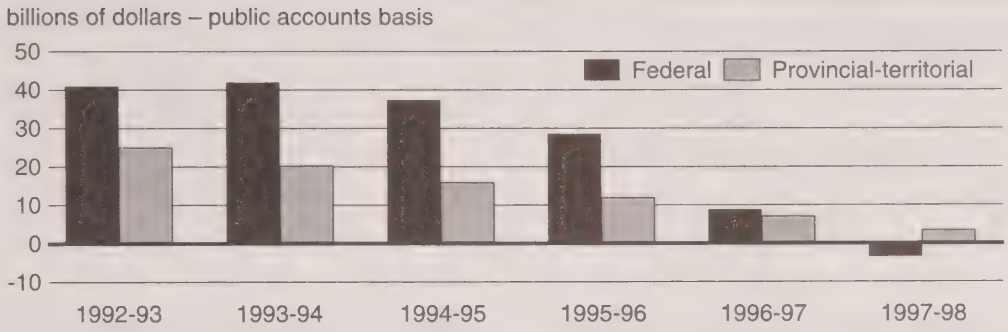
Business confidence



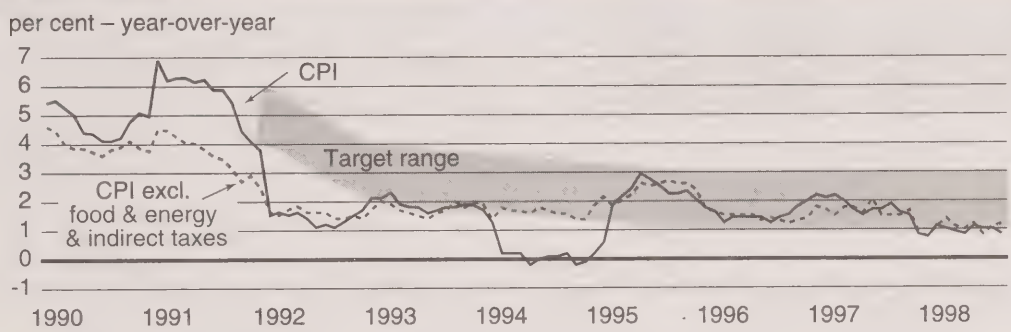
- High levels of consumer and business confidence fuelled the momentum in domestic demand that gathered strength over the last year-and-a-half.
  - Solid consumer confidence boosted strong growth in household spending.
  - Record levels of business confidence contributed to a surge in investment in 1997.
- The turbulence and uncertainty associated with the Asian crisis has shaken both consumer and business confidence from their historically high levels. However, confidence remains above levels witnessed at the beginning of the decade.
- Moreover, solid employment and income growth are favourable to continued growth in consumer spending, while allowing a recovery of the savings rate from the unprecedented negative level witnessed during the second quarter of 1998.

Canada's policy environment remains supportive of growth.

Federal and provincial–territorial deficits

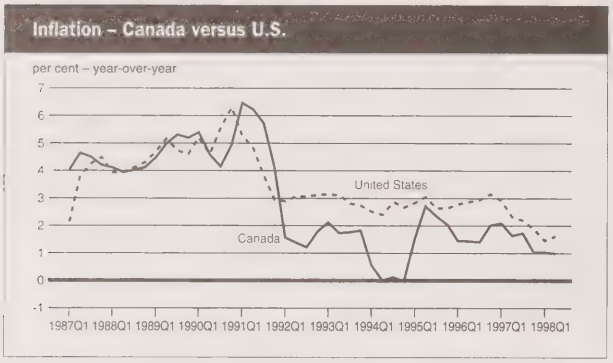


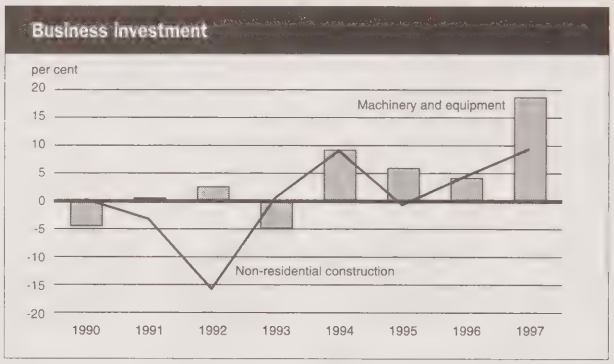
CPI inflation

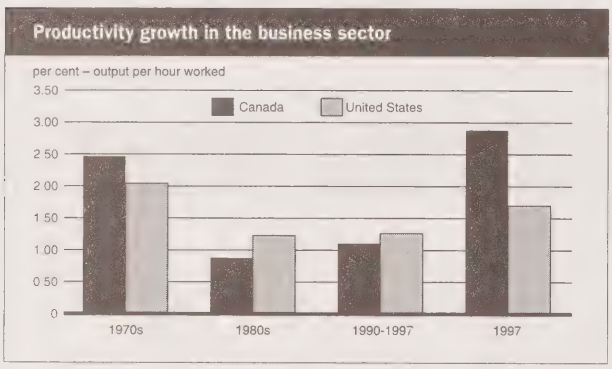


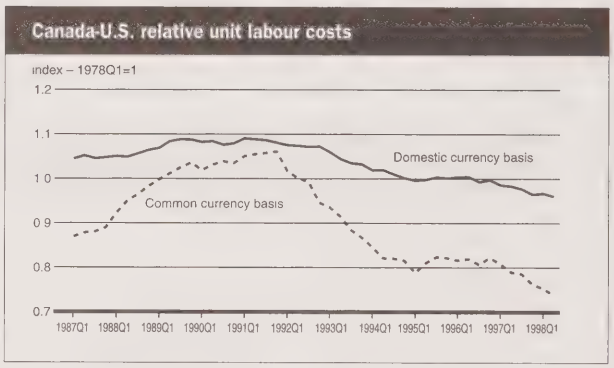
- Although there are still challenges ahead, Canada has made great strides toward establishing a policy environment supportive of sustained growth in the years to come.
- With the federal balance in surplus, and six provincial and territorial governments balanced or in surplus, Canada has made remarkable progress in restoring fiscal health. Indeed, a small surplus was recorded for the total government sector in 1997-98.
- Indeed, Canada's general financial balances have improved from the second worst among the G-7 countries (after Italy) in 1992 to the best in 1997, and are projected to lead all G-7 countries in 1998 and 1999 according to the Organization for Economic Co-operation and Development (OECD) *Economic Outlook*.
- Canada's commitment to low inflation has been amply demonstrated with inflation averaging less than 2 per cent over the last six years. The extension, in February 1998, of the 1- to-3-per-cent inflation target bands through 2001 further solidified this commitment.

Canada's policies have also increased competitiveness.









- Canada's success in maintaining low inflation is directly helping our competitiveness by containing costs.
- A low inflation environment and our success at eliminating the deficit has also led to improved confidence which, in turn, translated into strong investment growth in 1997.
- This is helping Canada to begin to close some of the productivity growth gap that emerged during the 1980s when Canada was hit harder than the U.S. by the general productivity slowdown seen in most industrial countries.
- During the 1990s, Canadian labour productivity growth lagged somewhat behind U.S. gains, in part due to a relatively slower average pace of real GDP growth. In 1997, as growth strengthened, Canadian labour productivity increased by 2.9 per cent. This marked the strongest annual gain in more than a decade and considerably outstripped U.S. productivity growth.
- Stronger productivity growth and moderate wage growth are translating into a decline in Canadian unit labour costs relative to the U.S. in both domestic and common currency terms.

Private sector forecasts for 1998 and 1999[1].

Expansion expected to continue but at a much slower pace than in 1997.

- The September consensus of private sector forecasters is that real GDP growth will be 2.9 per cent in 1998, down from the 3.5-per-cent pace expected in January. In 1999, growth is expected to slow to 2.2 per cent, down from January's expectation of 2.9 per cent.

- GDP inflation is also expected to be significantly lower in 1998 and 1999 than previously forecast. As a result, both the growth and level of nominal GDP are expected to be much lower in these years.

Interest rates are expected to remain low in 1998 and 1999.

- Private sector forecasters expect the 3-month Treasury bill rate to average 5.0 per cent in 1998 and 5.2 per cent in 1999.

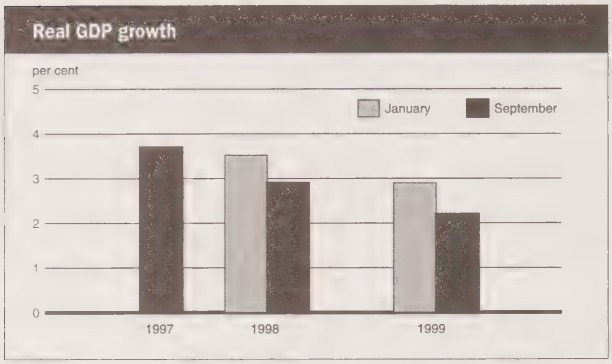
- The yield on Canadian 10-year government bonds is expected to average 5.4 per cent in both 1998 and 1999, down from 6.1 per cent in 1997.

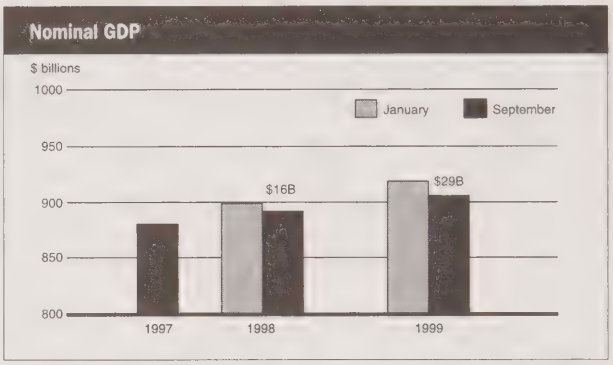
Evolution of private sector forecasts survey results

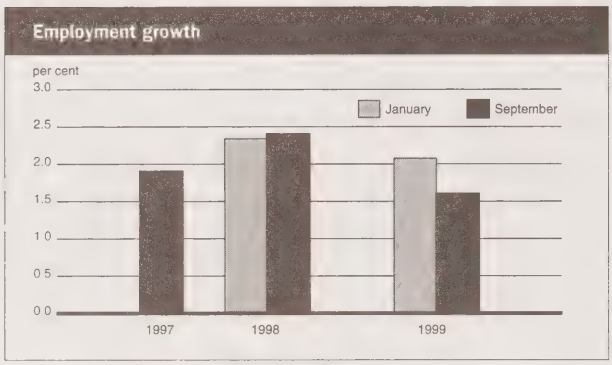
	1997	1998	1999
Real GDP growth (%)			
January 1998	3.8	3.5	2.9
September 1998	3.7	2.9	2.2
GDP inflation (%)			
January 1998	0.7	1.2	2.0
September 1998	0.5	0.1	1.3
Nominal GDP growth (%)			
January 1998	4.5	4.7	4.9
September 1998	4.2	3.0	3.5
Nominal GDP ($ billions)			
January 1998	857	897	941
September 1998	855	881	912
CPI inflation (%)			
January 1998	1.7	1.5	1.7
September 1998	1.6	1.2	1.6
Unemployment rate (%)			
January 1998	9.2	8.5	8.2
September 1998	9.2	8.4	8.3
Employment growth (%)			
January 1998	1.9	2.3	2.1
September 1998	1.9	2.4	1.6
3-month T-bill rate (%)			
January 1998	3.3	4.6	4.6
September 1998	3.3	5.0	5.2
10-year govt. bond rate (%)			
January 1998	6.2	5.9	6.0
September 1998	6.1	5.4	5.4

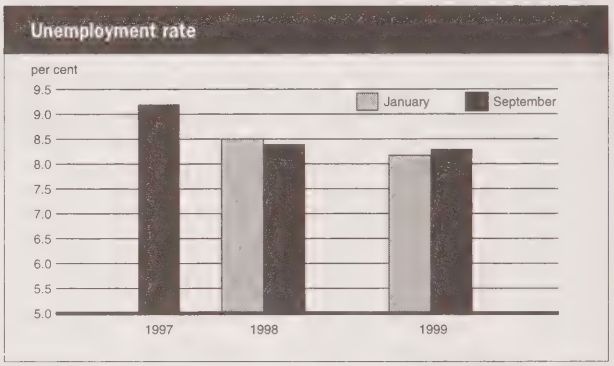
[1] Based on a survey of 24 private sector forecasters of which 20 responded to the September survey.

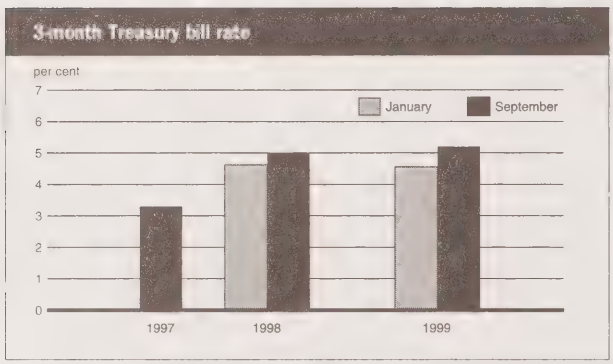
Private sector forecasts for 1998 and 1999.

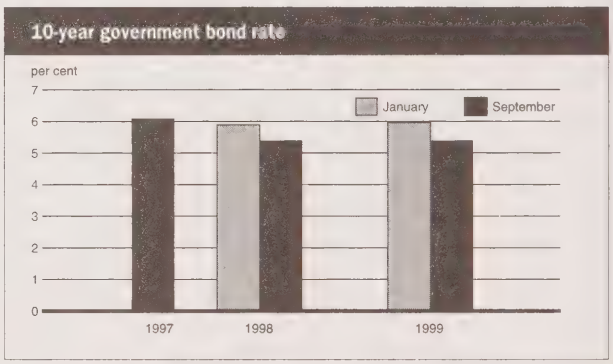






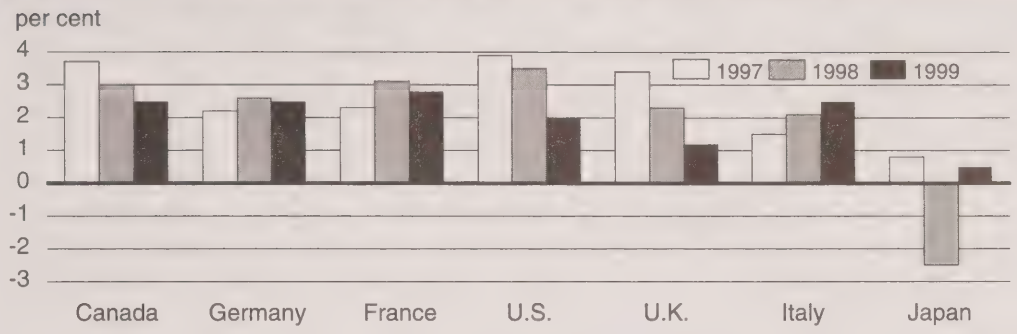




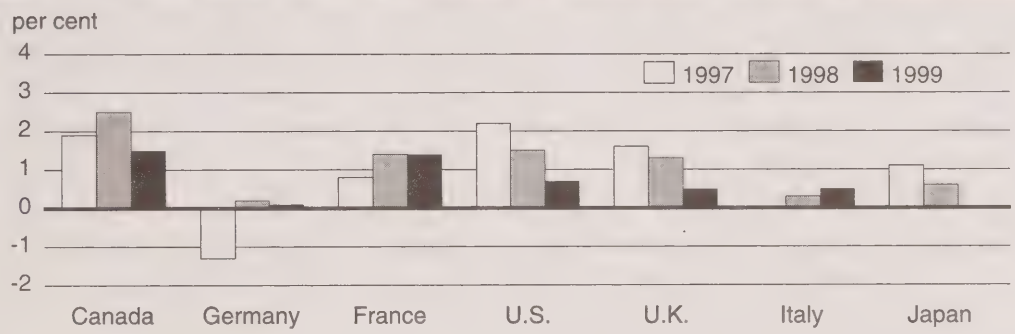


Canada is still expected to be near the top of the G-7 in growth in 1998 and 1999 and to lead in job creation.

IMF forecasts for Canadian real GDP growth for 1998 and 1999



IMF forecasts for Canadian employment growth for 1998 and 1999



Source: IMF *World Economic Outlook*, September 1998.

- Major international organizations remain very positive about Canada's prospects for real GDP and employment growth.
  - For example, in its September forecast, the IMF still expects that Canada's real GDP growth will compare favourably with the other G-7 countries in both 1998 and 1999.
  - And the IMF expects Canada to be well ahead of the other G-7 countries in employment growth in 1998 and 1999.

2

Canada's Historic Fiscal Progress

Highlights

"Five years ago, the federal deficit stood at $42 billion and rising. We said we would bring it down steadily each and every year. And we did – not only meeting, but beating every target we set."

"I am pleased to announce that, for the first time in more than a generation, the Government of Canada recorded a surplus – $3.5 billion ... This is a historic milestone. And it is an achievement that belongs not to government but to Canadians themselves."

"... Canada has in fact recorded a financial surplus for two years in a row – the only G-7 country to do so."

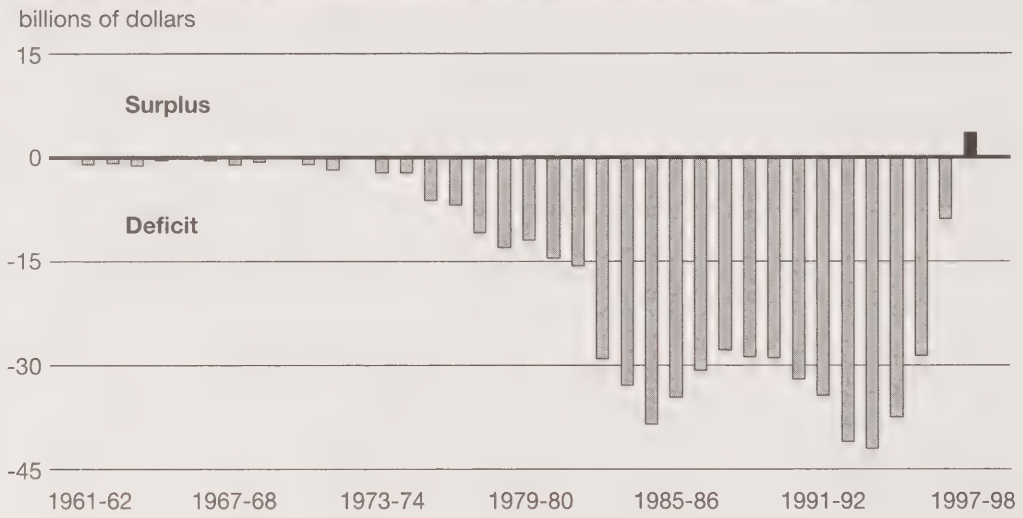
"... We paid down $9.6 billion of market debt last fiscal year. And we will likely be able to report a significant further paydown at the end of the current fiscal year as well."

The Honourable Paul Martin
Minister of Finance

- *The federal government recorded a budgetary surplus of $3.5 billion in 1997-98 – the first since 1969-70.*
- *Since 1993-94, the federal budget has swung from a budgetary deficit of $42 billion to a budgetary surplus of $3.5 billion – a $45.5 billion improvement in just four years.*
- *The fiscal turnaround primarily reflects discretionary actions to reduce and reform program spending and the positive impact of a growing economy on budgetary revenues.*
- *In 1997-98, total program spending as a percentage of the economy (GDP) stood at 12.7 per cent, a decline of 3.9 percentage points since 1993-94. This is the lowest ratio since 1949-50.*
- *The budgetary surplus means that the net public debt fell from $583.2 billion in 1996-97 to $579.7 billion in 1997-98 – the first decline in the absolute level of the net public debt since 1969-70.*
- *The debt-to-GDP ratio is now on a permanent downward track. It fell 3.3 percentage points to 67.8 per cent in 1997-98 – the largest single year decline since 1956-57.*
- *The 1997-98 fiscal year marked the second consecutive year that the government had a financial surplus – the difference between cash coming in to the government and cash going out – the first back-to-back financial surpluses since 1965-66.*
- *The government retired $9.6 billion of market debt in 1997-98.*
- *Fiscal progress at the federal level has been complemented by progress at the provincial level. The aggregate federal-provincial budgetary balance has swung from a record deficit of $66 billion in 1992-93 to a small surplus in 1997-98.*

The federal government went into surplus in 1997-98 – the first time since 1969-70.

Federal budgetary balance
(public accounts basis)



- The federal government recorded a budgetary surplus of $3.5 billion in 1997-98 – the first since 1969-70. This is a sharp improvement from 1993-94 when there was a budgetary deficit of $42 billion.
- The improvement in the federal budgetary balance is the most dramatic turnaround in federal government finances since the Second World War demobilization.
- The budgetary surplus means that the absolute level of the net public debt fell by a corresponding amount in 1997-98.

The 1997-98 surplus reflects a strong economy and continued fiscal restraint.

Financial highlights
(public accounts basis)

	1996-97	1997-98	Change
		billions of dollars	
Budgetary revenues	140.9	153.2	12.3
Program spending	104.8	108.8	3.9
Public debt charges	45.0	40.9	-4.0
Budgetary balance	-8.9	3.5	12.4

Numbers may not add due to rounding.

- The federal budgetary balance moved from a deficit of $8.9 billion in 1996-97 to a surplus of $3.5 billion in 1997-98, an improvement of $12.4 billion.
- A rebound in economic growth, accompanied by strong employment gains, a drop in the unemployment rate to its lowest level in eight years, robust corporate profit growth and higher consumer spending, increased revenues by $12.3 billion.
- Although program spending was up $3.9 billion, more than all of the increase was due to one-time factors totalling $5.5 billion: the Canada Millennium Scholarship Foundation ($2.5 billion); a change in accounting for assistance to international financial institutions ($1.8 billion); compensation for hepatitis C victims ($0.8 billion); and the aboriginal healing strategy ($0.35 billion). Net of these one-time adjustments, program spending would have declined $1.5 billion due to the impact of restraint measures introduced in the 1995 and 1996 budgets.
- The decline in public debt charges was due to a lower average effective interest rate on interest-bearing debt, an absolute decline in the stock of interest-bearing debt, and a change in accounting for interest costs related to public sector pension plans, as recommended by the Public Sector Accounting and Auditing Board and the Auditor General.

The outcome for 1997-98 was better than anticipated in the 1998 budget.

1997-98 outcome and 1998 budget projection
(public accounts basis)

	Outcome	1998 budget estimate	Change
		billions of dollars	
Budgetary revenues	153.2	147.5	5.7
Program spending	108.8	106.0	2.8
Public debt charges	40.9	41.5	-0.6
Budgetary balance	3.5	0.0	3.5

Numbers may not add due to rounding.

- The 1997-98 outcome bettered the 1998 balanced budget estimate by $3.5 billion.
- Most of the better outcome was due to stronger-than-expected revenues ($5.7 billion greater than estimated in the budget), primarily reflecting strong personal and corporate income tax receipts at the end of 1997-98 and adjustments relating to previous fiscal years.
- Public debt charges were $0.6 billion lower.
- The better-than-estimated revenue growth and lower public debt charges were offset somewhat by higher program spending ($2.8 billion greater than estimated in the budget), attributable to higher-than-expected end-of-year accounting adjustments for liabilities incurred during the year.

Fiscal progress since 1993-94 has been due to a growing economy and a reduction in program spending.

Sources of changes in the federal budgetary balance
(public accounts basis)

	1993-94 to 1997-98
	billions of dollars
Factors reducing the federal deficit	
Higher revenues due to economic growth	31.2
Reduction in program spending	16.8
One-time revenue adjustments	3.7
Revenue-raising measures	2.3
Subtotal	54.0
Factors increasing the federal deficit	
Cost of one-time expenditure initiatives	5.5
Increase in debt charges	2.9
Subtotal	8.4
Net improvement in the federal budgetary balance	45.5

Numbers may not add due to rounding.

- The federal budget balance has improved from a deficit of $42 billion in 1993-94 to a surplus of $3.5 billion in 1997-98 – *a $45.5 billion turnaround in just four years.*
- Budgetary revenues increased $37.2 billion. Of this amount, about $31 billion is attributable to economic developments (about 90 per cent of this amount was due to the growth in the economy while about 10 per cent is due to the interaction between the tax system and rising incomes). One-time factors, which depressed revenues in 1993-94 but increased revenues in 1997-98, accounted for about $3.7 billion. Net revenue-raising measures introduced since 1993 (primarily aimed at removing and reducing tax preferences, increasing fairness and ensuring taxpayers pay the taxes they owe when they are due) accounted for an additional $2.3 billion.
- Program spending declined $11.3 billion. This reflects a decline in ongoing program spending of $16.8 billion, partly offset by $5.5 billion of one-time spending initiatives/accounting changes in 1997-98.
- Partially offsetting these positive developments were somewhat higher public debt charges, due to a higher stock of interest-bearing debt.

Fiscal progress since 1993-94: an alternative measure.

Changes relative to growth in economy
(public accounts basis)

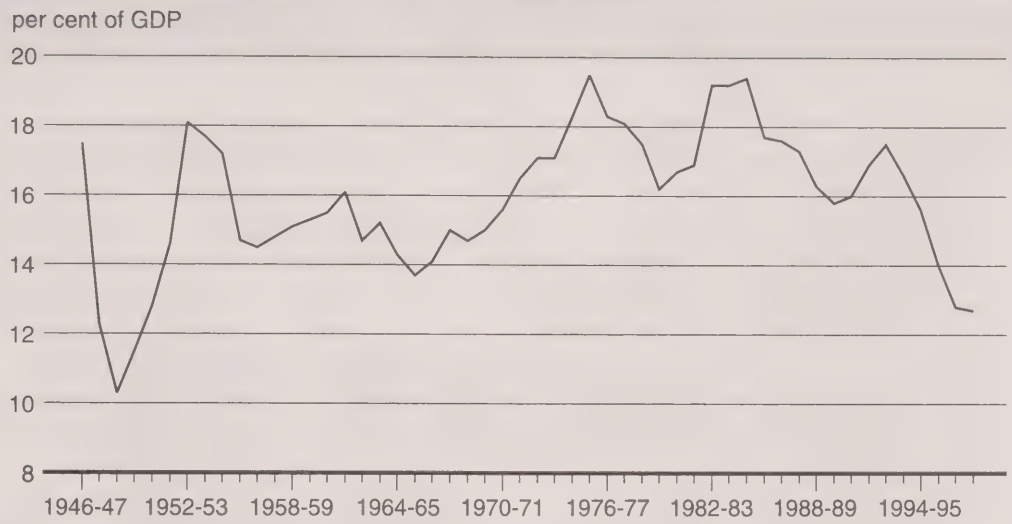
	1993-94	1997-98	Change	Contribution
	per cent of GDP			(%)
Budgetary revenues	16.0	17.9	1.9	30.8
Program spending	16.6	12.7	3.9	61.9
Public debt charges	5.2	4.8	0.5	7.3
Budgetary balance	-5.8	0.4	6.2	100.0

Numbers may not add due to rounding.

- The contribution of revenue increases and expenditure reductions to the improvement in the budgetary balance is best illustrated by looking at the evolution of budgetary revenues, program spending, public debt charges and the resulting budgetary balance as a share of the economy.
- Since 1993-94, the budgetary balance swung from a deficit of 5.8 per cent of gross domestic product (GDP) to a surplus of 0.4 per cent of GDP, an improvement of 6.2 percentage points.
- Less than one-third of the improvement in the budgetary balance was due to an increase in the revenue yield (revenues as a share of GDP). This reflects the impact of one-time factors which depressed revenues in 1993-94 but increased them in 1997-98, revenue-raising measures introduced since 1993, the interaction of the tax system with rising incomes, and the exclusion from nominal GDP of certain components of income subject to taxation (for example, capital gains and income from pension plans).
- Over 60 per cent of the improvement in the budgetary balance was due to the fall in program spending as a share of GDP. This primarily reflects the impact of the discretionary actions taken since 1993, including the expenditure reduction actions taken in the 1995 and 1996 budgets as a result of the Program Review.
- Public debt charges, as a percentage of GDP, declined slightly as a result of a decline in the average effective rate on the government's interest-bearing debt, a slowing in the rate of growth in interest-bearing debt, and a change in accounting for interest costs related to public sector pension plans.

Program spending continues to decline as a share of GDP.

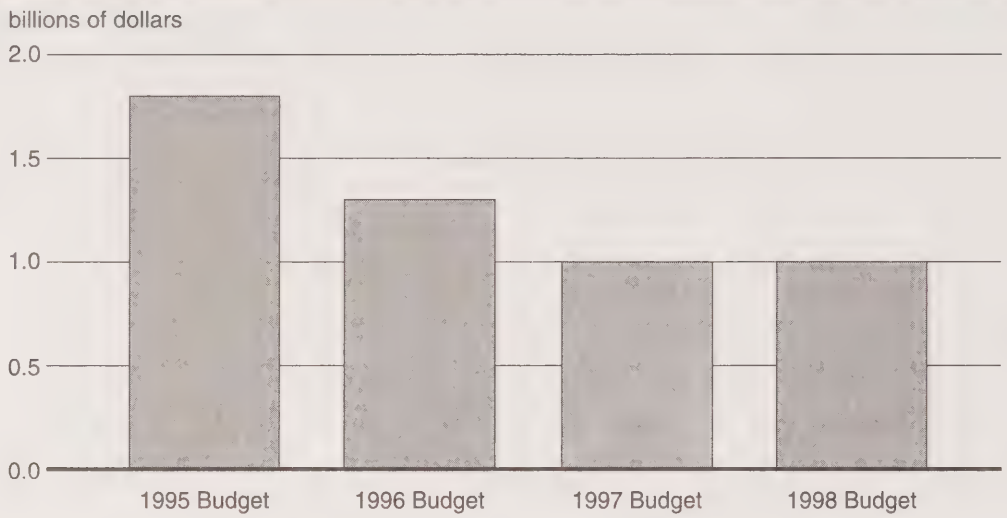
Federal program spending to GDP
(public accounts basis)



- The reforms to program spending undertaken since 1993-94, coupled with strong economic growth, reduced program spending as a percentage of GDP to 12.7 per cent – its lowest ratio since 1949-50 when it was 11.5 per cent.
- Since 1993-94, the ratio has declined 3.9 percentage points. This decline was primarily the result of a fundamental review of all federal government programs, beginning with the 1994 budget and followed up in the 1995 and 1996 budgets. This review was conducted in two parts: most components of direct program spending (total program spending less major transfers to persons and other levels of government) were subject to the Program Review exercises, while major transfers to other levels of government and employment insurance benefits were reviewed separately, to ensure that they would be sustainable over the long term.

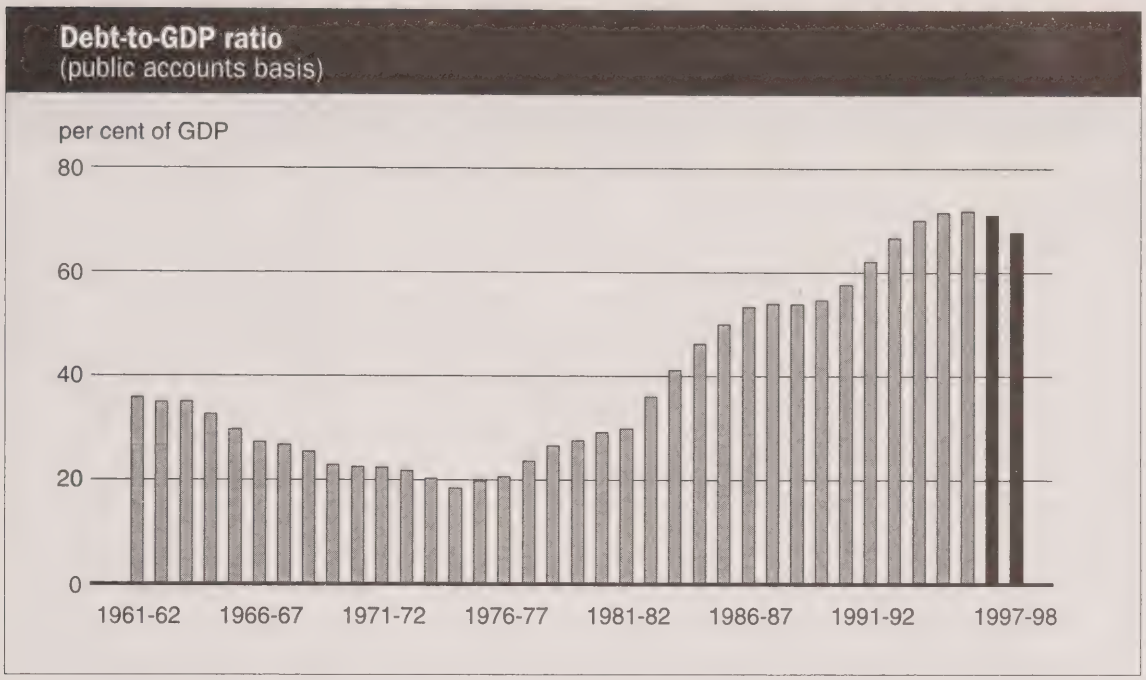
The sensitivity of debt charges to interest rate changes has been reduced.

Sensitivity of public debt charges to 100-basis-point increase in all interest rates: first year impact
(public accounts basis)



- With the high stock of interest-bearing debt, public debt charges represent the largest component of total federal expenditures. It is important, therefore, that the government's debt operations be managed to raise stable low-cost funding and to protect against unexpected changes in interest rates.
- The government has restructured the debt stock to ensure that it is less sensitive to changes in interest rates.
- It has achieved this by increasing the fixed rate share of the government's gross debt to 65 per cent in 1997-98 from 53 per cent in 1993-94.
- As a result, the impact of a 100-basis-point increase in interest rates on the budget balance in the first year of the increase is now about $800 million lower today than at the time of the 1995 budget (i.e. $1 billion compared to $1.8 billion).

The debt-to-GDP ratio is on a permanent downward track.



- With the budget in surplus in 1997-98, the net stock of federal government debt declined.
- However, the best indicator of the burden of debt on the economy is the debt-to-GDP ratio.
- In 1997-98, the debt-to-GDP ratio fell to 67.8 per cent from 71.1 per cent in 1996-97 – a 3.3-percentage-point decline.
- This is the largest single year decline in the debt-to-GDP ratio since 1956-57.
- The debt-to-GDP ratio has declined for two consecutive years – a total of 4.1 percentage points from its peak of 71.9 per cent in 1995-96 – the first back-to-back declines in the debt ratio in over 20 years.
- Through its Debt Repayment Plan, the government is committed to ensuring that the debt-to-GDP ratio continues on a permanent downward track.

There was a financial surplus of $12.7 billion in 1997-98.

Budgetary balance and financial requirements/surplus
(public accounts basis)

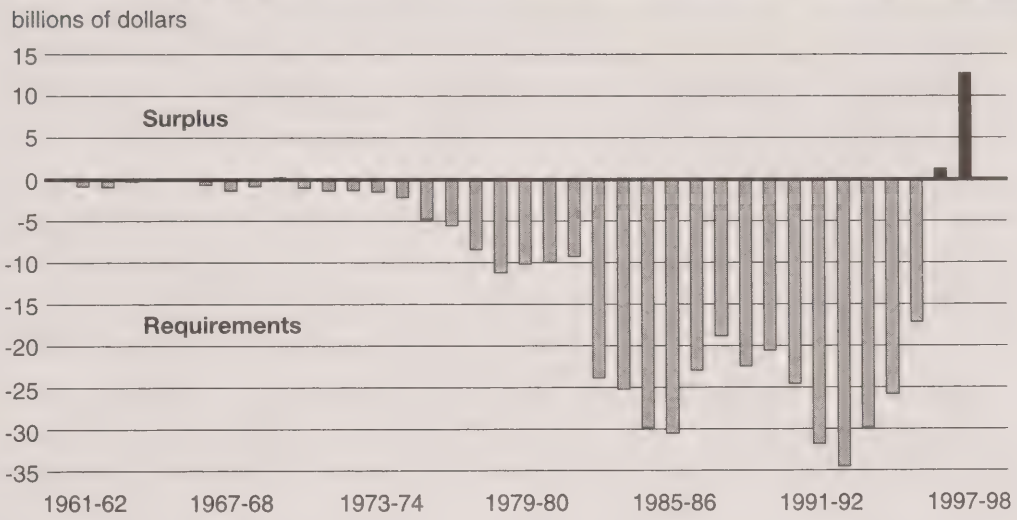
	1996-97	1997-98
	billions of dollars	
Budgetary balance: surplus(+) / deficit (-)	-8.9	3.5
Non-budgetary transactions		
Public sector pension and other accounts	6.9	3.8
Loans, investments and advances	0.3	2.0
Other transactions	3.0	3.4
Total	10.2	9.3
Financial requirements/surplus (excluding foreign exchange transactions)	1.3	12.7

Numbers may not add due to rounding.

- The budgetary deficit/surplus – the budgetary balance – is but one measure of the government's financial position. It is the most comprehensive measure as it includes liabilities incurred by the government regardless of when the actual cash payment is made.
- However, another important measure of the government's financial position is financial requirements/surplus which measure the difference between cash coming in to the government and cash payments made for programs and public debt charges. Thus, financial requirements/surplus do not include liabilities incurred by the government during the year for which there is no cash payment made.
- The adjustments required to convert the budgetary balance to financial requirements/surplus are included in non-budgetary transactions. The largest adjustment relates to the pension accounts for the government's employees which report the net flow of funds into these accounts. Other non-budgetary categories include the government's net investments in loans, investments and advances (primarily to its enterprise Crown corporations and sovereign governments). Other transactions primarily include the adjustments to convert the accrual figures included in the budgetary balance to a cash basis.
- With a budgetary surplus of $3.5 billion and a net source of funds of $9.3 billion from non-budgetary transactions, the financial surplus, excluding foreign exchange transactions, amounted to $12.7 billion in 1997-98, up from a surplus of $1.3 billion in 1996-97.

There has been a financial surplus for two consecutive years.

Financial requirements/surplus (excluding foreign exchange transactions)
(public accounts basis)



- The financial surplus, excluding foreign exchange transactions, of $12.7 billion in 1997-98 marks the second consecutive year in which a surplus was recorded and the first consecutive financial surpluses since 1965-66. This is a dramatic improvement since 1992-93 when financial requirements amounted to $34.5 billion.
- The financial balance is broadly comparable to the measures of the budgetary balance used by other major industrialized countries, including the United States. On this basis, Canada and the United States are the only Group of Seven (G-7) countries in surplus positions in 1997-98 (measured in terms of their respective fiscal years).

Market debt declined $9.6 billion.

Federal government financial assets and liabilities
(public accounts basis)

	1996-97	1997-98	Change
		billions of dollars	
Interest-bearing debt			
Market debt	476.9	467.3	-9.6
Public sector pensions/other accounts	123.7	127.5	3.8
Total	600.6	594.8	-5.8
Current liabilities and allowances	40.1	43.7	3.6
Financial assets[1]	-57.5	-58.8	-1.4
Net public debt	583.2	579.7	-3.5

Numbers may not add due to rounding.

[1]Financial assets are shown as a negative entry because they reduce the net debt.

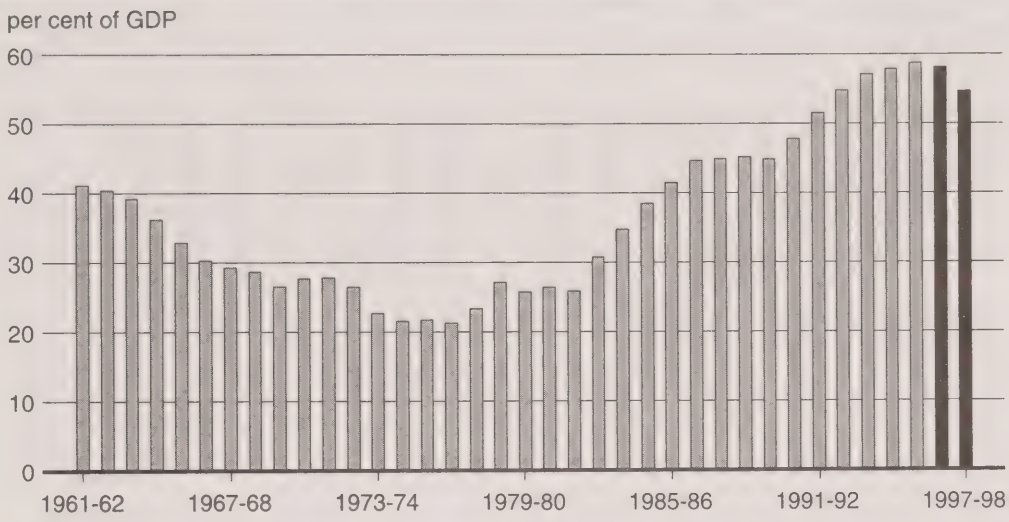
- Net public debt of $579.7 billion in 1997-98 consisted of interest-bearing debt ($594.8 billion), current liabilities and allowances ($43.7 billion) – primarily accounts payable – and financial assets ($-58.8 billion), consisting of cash, accounts receivable, assets in the foreign exchange account, investments in Crown corporations and loans to other governments.

- Interest-bearing debt consists of market debt and the government's liabilities to the federal employees' pension plans and other accounts. The former refers to debt issued on credit markets in the form of Government of Canada bonds, Canada Savings Bonds and Treasury bills. In 1997-98, market debt declined by $9.6 billion while the liabilities to the public sector pensions and other accounts increased by $3.8 billion.

- The government's liabilities to the public sector pensions and other accounts will continue to increase over time. However, with a commitment to balanced budgets in 1998-99 and in 1999-2000, net public debt will remain constant while the stock of market debt will continue to decline.

Market debt declined as a share of GDP for a second consecutive year.

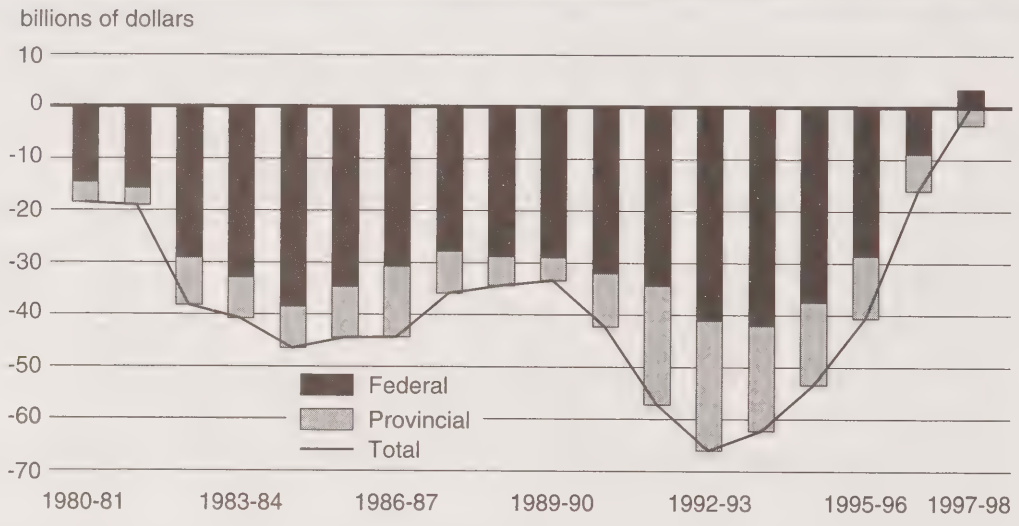
Market debt
(public accounts basis)



- Market debt as a percentage of GDP fell from 58.1 per cent in 1996-97 to 54.6 per cent in 1997-98 – a decline of 3.5 percentage points.
- The decline in market debt-to-GDP in 1997-98 was the largest since 1973-74 when it fell 3.8 percentage points.
- Since 1995-96, market debt as a share of GDP has fallen 4.2 percentage points – the first back-to-back decline since 1973-74.

The aggregate federal-provincial budget is now in a surplus.

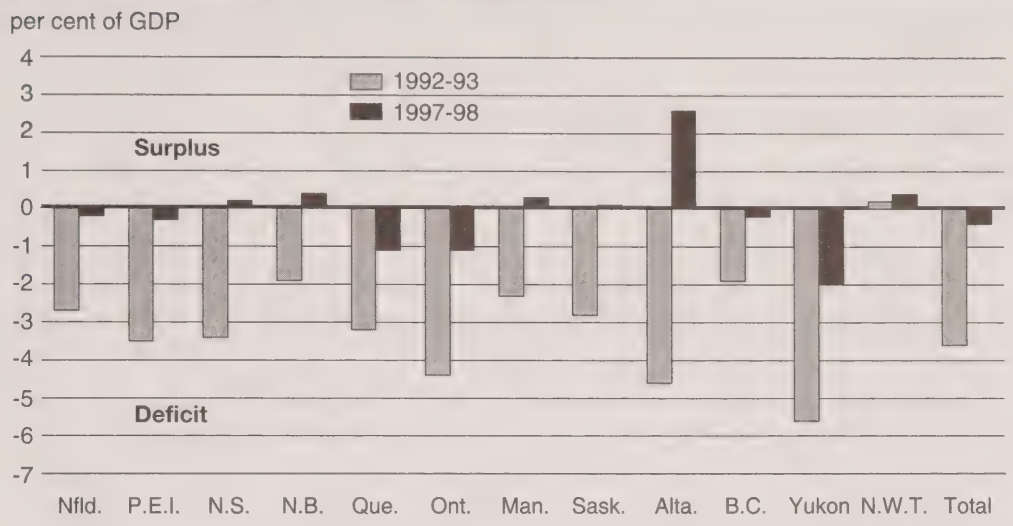
Total federal and provincial deficit/surplus
(public accounts basis)



- Fiscal progress at the federal level has been complemented by progress at the provincial level.
- From its peak of $25 billion in 1992-93, the provincial-territorial deficit declined to $3.4 billion in 1997-98.
- The aggregate provincial-territorial budget is projected to be in balance by 2000-01.
- The total government sector budgetary balance has swung from a deficit of $66 billion in 1992-93 to a small surplus of $0.1 billion in 1997-98.

Half of the provinces and territories realized balanced budgets.

Provincial-territorial budgetary balances
(public accounts basis)



Source: Department of Finance, Canada.

- Five provinces and one territory realized a balanced budget or surplus last year.
- This represents a substantial improvement from 1992-93 when all but one of the 12 provincial-territorial budgets were in deficit.

Provincial program spending has been declining as a share of the economy.

Federal and provincial program spending
(public accounts basis)



- As has been the case at the federal level, deficit reduction at the provincial-territorial level has been achieved primarily through spending reductions.
- From 1992-93 to 1997-98, provincial-territorial program spending has declined by 3.7 percentage points to 16.4 per cent of GDP.
- This compares to a decline of 4.8 percentage points at the federal level.

3

The Challenge of Reducing Canada's Debt Burden

Highlights

"... it is clear that a quarter century of deficits has left us with a debt burden that is still far too high."

"Too much of every tax dollar goes to pay interest on the debt rather than to purposes that are productive – for the country and for Canadians."

"... our commitment is to keep the debt-to-GDP ratio falling permanently. The Debt Repayment Plan we put in place in the last budget will ensure that happens."

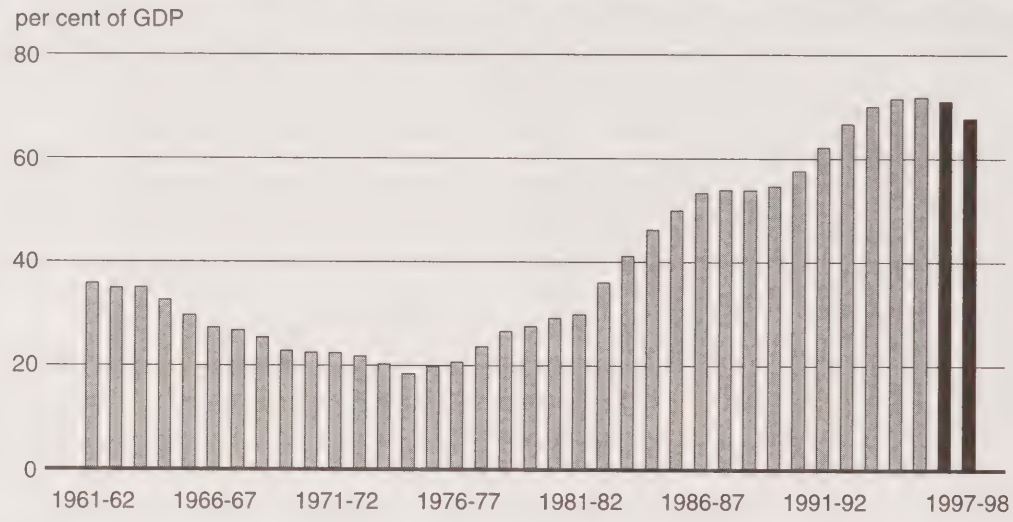
"Our commitment to continued financial progress is rock solid."

The Honourable Paul Martin
Minister of Finance

- *The absolute level of the net public debt declined in 1997-98 – the first decline since 1969-70.*
- *The debt in relation to the level of income generated in the economy – the debt-to-GDP ratio – declined in both 1996-97 and 1997-98 – the first back-to-back declines since the early 1970s.*
- *The federal debt-to-GDP ratio, while declining, is still high in relation to historical experience and the debt-to-GDP ratios of provincial governments.*
- *The portion of every federal revenue dollar consumed by public debt charges in 1997-98 was down to 27 cents from a peak in 1995-96 of 36 cents.*
- *Even at 27 cents, the share of each federal revenue dollar consumed by public debt charges is still high compared to the 13 cents for provincial government revenues.*
- *Recent improvements in Canada's international debt standing must continue in order to maintain and enhance Canada's attractiveness as a location for investment.*
- *Reducing the debt burden now is critical to ensuring that future generations are not left an unduly high tax burden.*
- *The Debt Repayment Plan will ensure that, at a minimum, with the budget in balance, the debt-to-GDP ratio will continue to fall steadily.*

The federal debt-to-GDP ratio is declining but is still high by historical standards.

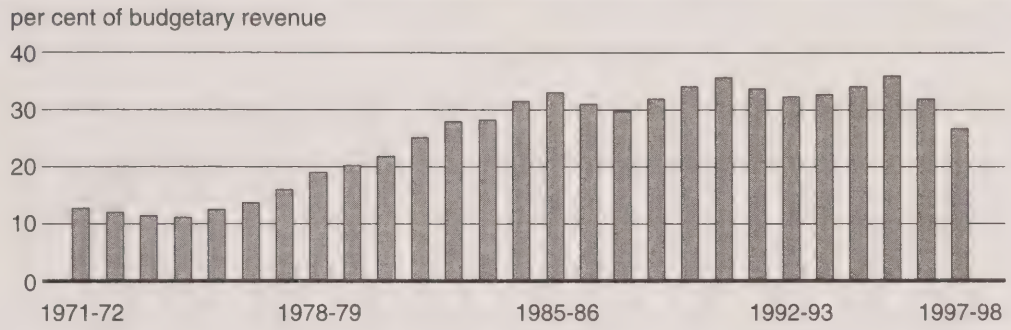
Net public debt-to-GDP ratio
(public accounts basis)



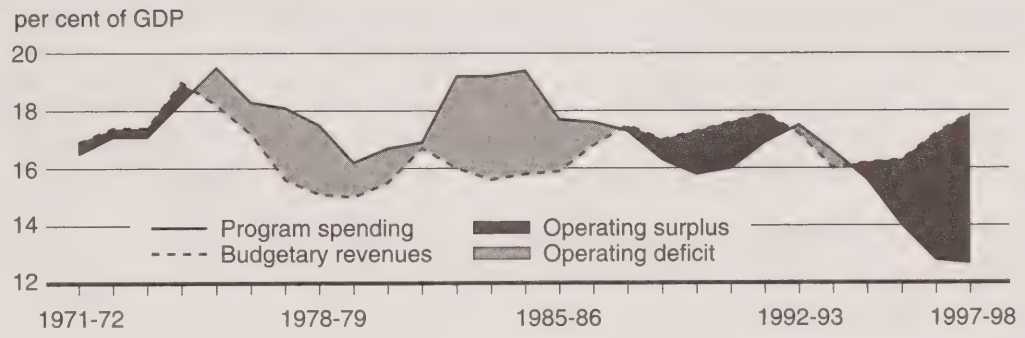
- The net public debt is the accumulation of budgetary deficits and surpluses since Confederation.
- The most appropriate indicator of the burden of the debt is not the absolute level of the debt but its level in relation to total income generated in the economy – the debt-to-GDP ratio. Just as households with higher incomes can support larger mortgages, countries with higher levels of output and incomes can support a larger level of debt.
- The burden of debt remains extremely high by historical Canadian standards – it has only fallen back to where it was prior to 1993-94.

The cost of servicing the debt requires operating surpluses.

Debt servicing costs as a share of revenues
(public accounts basis)



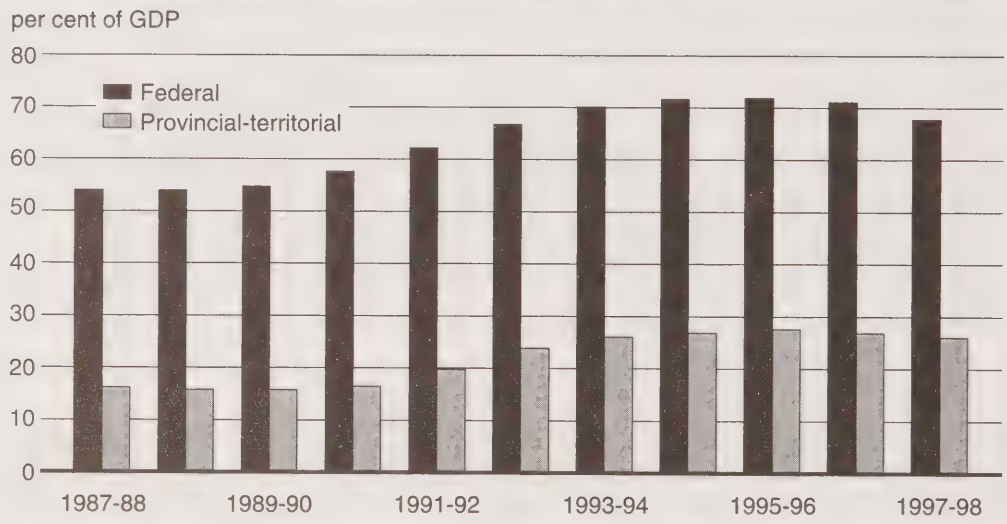
Operating balance
(public accounts basis)



- Another indicator of the burden of debt is the portion of each revenue dollar that must go to paying interest on the debt and the implications this has for the operating balance – revenues less program spending.
- The ratio of debt charges to total revenues has begun to decline as the deficit has been eliminated. In 1997-98, 27 cents of every dollar of revenue went to servicing the debt, down from a peak in 1995-96 of almost 36 cents. Of this decline, 1.8 cents was attributable to the accounting change for interest costs related to public sector pension plans.
- But the cost of servicing this debt remains high. And this means that, just to keep the budget in balance, the government must run large operating surpluses – in other words, revenues must exceed program expenditures by a wide margin. Therefore, the cost of servicing the debt reduces the monies available that could otherwise be used to reduce taxes and fund priority programs.

The federal debt ratio has been more than twice as high as the total provincial government ratio.

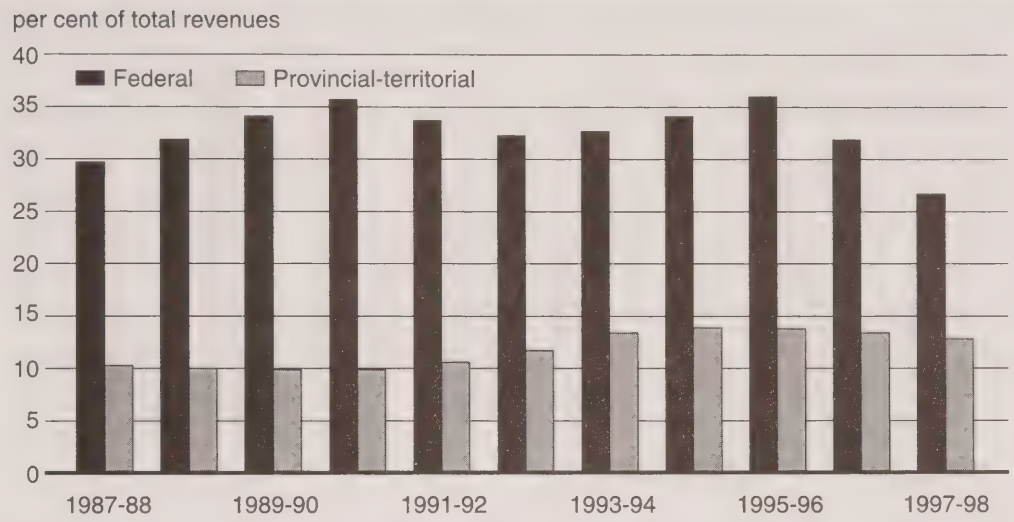
Federal and provincial-territorial net debt
(public accounts basis)



- Relative to the size of the economy, the federal debt has been more than twice as high as provincial-territorial debt ratios throughout the past decade.
- In 1997-98, the federal debt ratio was 67.8 per cent of GDP compared to 26.1 per cent for the provinces and territories.

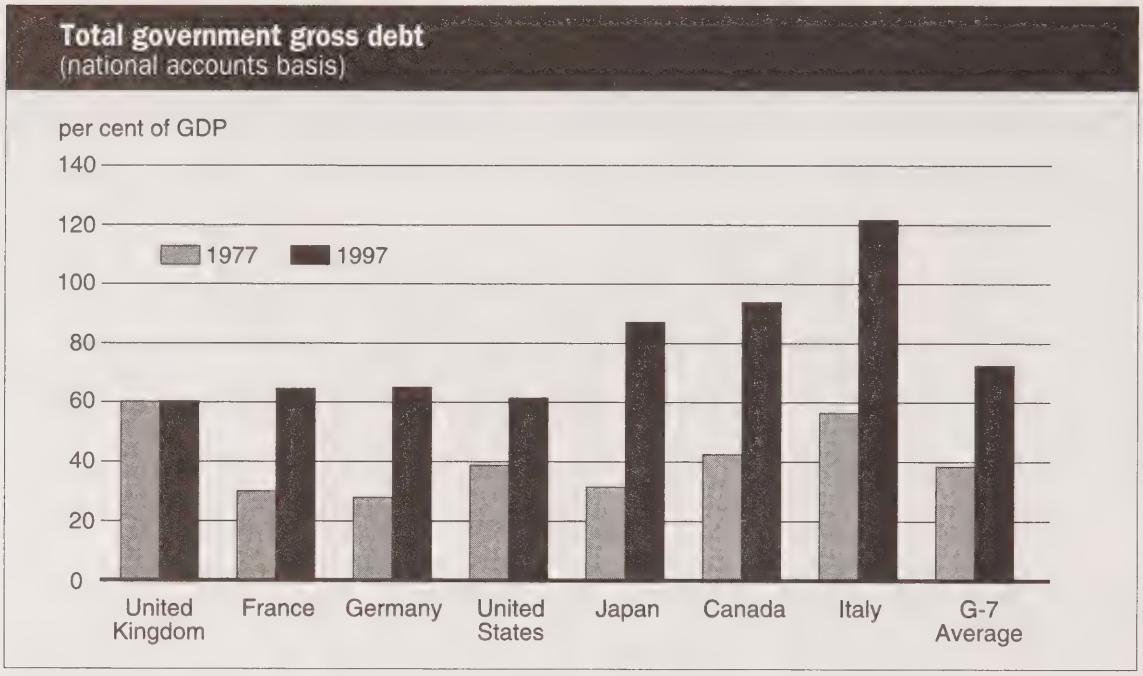
Debt charges as a per cent of revenues are higher at the federal level.

Federal and provincial-territorial debt charges
(public accounts basis)



- The higher federal debt ratio means that debt charges take up far more federal revenue than at the provincial-territorial level.
- In 1997-98, debt charges consumed 13 cents of every dollar in revenue raised by provincial-territorial governments compared to about 27 cents at the federal level.

Canada's public debt is high by international standards.

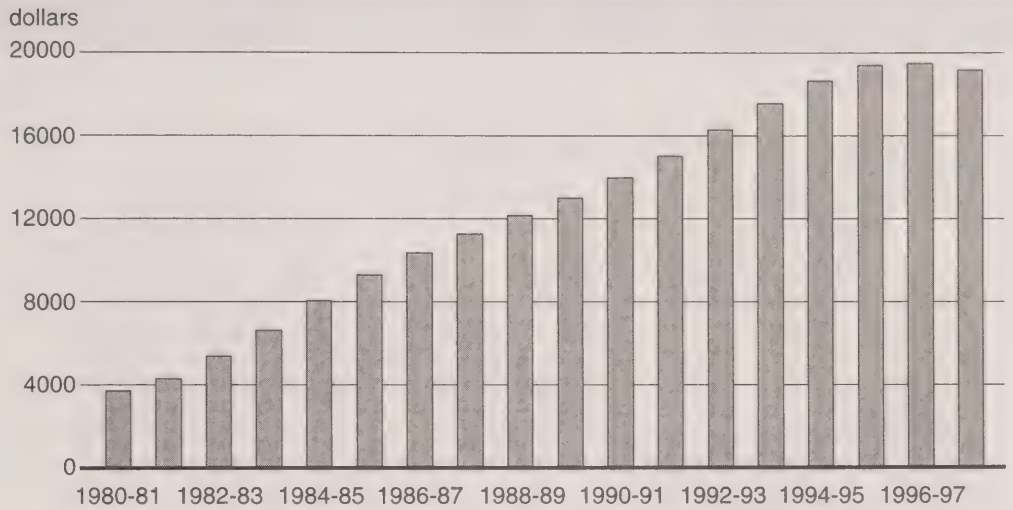


Source: OECD *Economic Outlook* No. 63 (June 1998).

- The deterioration in Canada's total government (federal, provincial and local governments, and the balances in the Canada and Quebec Pension Plans) debt-to-GDP ratio, which started in the mid-1970s, was a feature common to most other Group of Seven (G-7) countries.
- However, in Canada's case, the deterioration was among the most pronounced.
- Between 1977 and 1997, growth in the total government debt in Canada resulted in the second highest gross debt-to-GDP ratio of the G-7 countries (to ensure comparability across countries, this chart uses national accounts data).
- Improving Canada's international debt standing is critical to maintaining Canada's attractiveness as a location for investment.

Reducing the debt burden is also a matter of fairness towards future generations.

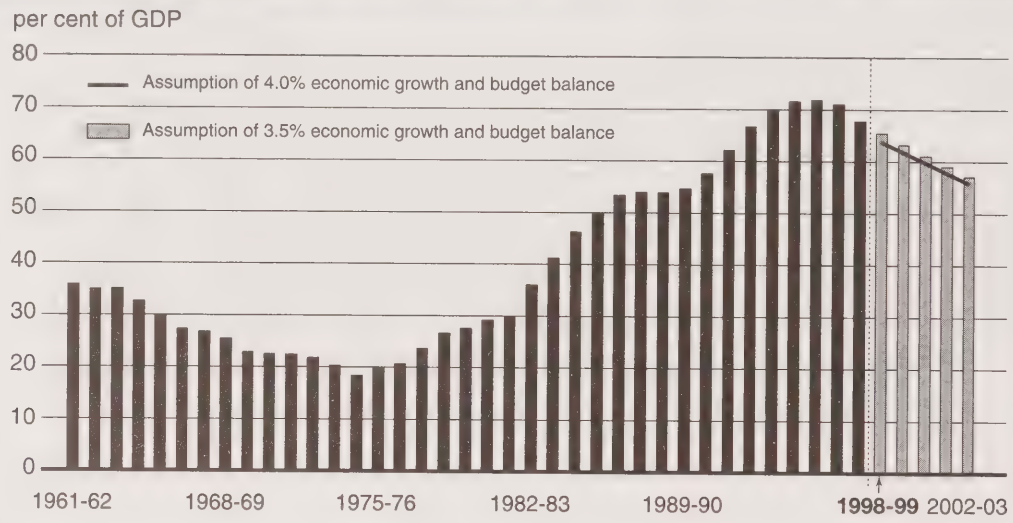
Net debt per capita



- Reducing the debt-to-GDP ratio will ensure that the legacy left to future generations is one of sound economic and social policies, not one of high debt and high taxes.
- Much of the current debt is related to the past consumption of goods and services rather than spending on investments in the economy.
- The debt-to-GDP ratio must be reduced while the generations that benefited the most from its run-up are still in the labour force. This is a matter of fairness.

The Debt Repayment Plan, combined with sustained economic growth, will ensure a continuing decline in the debt-to-GDP ratio.

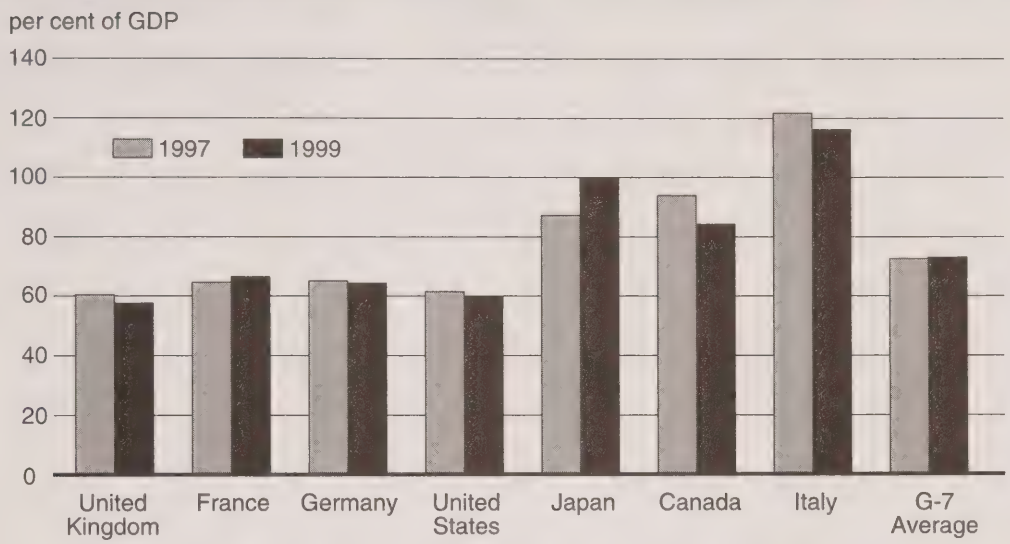
Debt-to-GDP ratio
(public accounts basis)



- The Debt Repayment Plan consists of: two-year fiscal plans based on prudent economic assumptions, a commitment to balanced budgets, a $3 billion Contingency Reserve, and a commitment to use the Contingency Reserve to pay down the debt if it is not needed.
- The key to reducing the debt-to-GDP ratio is sustained long-term economic growth and – at a minimum – ensuring that the budget remains in balance.
- Assuming economic growth (nominal GDP growth) averages 4 per cent annually and an annual budget balance (in other words, holding the net debt at its current level), by 2002-03, the debt-to-GDP ratio would fall to about 55 per cent. If nominal economic growth averaged 3.5 per cent, the debt ratio would fall to 57 per cent by 2002-03. Thereafter, the debt-to-GDP ratio would decline by about 2 percentage points each year.
- If, year by year, the Contingency Reserve is not required and hence goes to paying down the debt, then the respective debt ratios would be about 1.5 percentage points lower by 2002-03.

The debt burden will also decline in relation to other G-7 countries.

Total government gross debt
(national accounts basis)



Source: OECD Economic Outlook No. 63 (June 1998).

- The Debt Repayment Plan will also ensure that the debt-to-GDP ratio in Canada will continue to decline faster than in other countries.
- According to Organization for Economic Co-operation and Development (OECD) projections, which are based on existing government programs and policies, Canada's gross debt-to-GDP ratio on a national accounts basis will decline by over 9 percentage points between 1997 and 1999, the largest decline of any of the G-7 countries.

4

Strengthening Productivity and Improving the Living Standards of Canadians

Highlights

"The goal of that effort is to raise the standard of living and the quality of life for all Canadians."

"And the only way to get there is to continue, year after year, to put in place the foundation for a stronger, more productive economy."

"... we put in place a long-term plan. Its goal? To provide Canadians with what had been absent for too long: the architecture of a modern, productive economy, one of growth and jobs."

The Honourable Paul Martin
Minister of Finance

- *The central objective of economic policy is to enhance the well-being of people through higher living standards.*
- *The best measure of the living standards is real gross domestic product (GDP) per capita.*
- *Growth in real GDP per capita has slowed markedly in Canada in recent decades.*
- *The government's economic strategy is aimed at reversing this trend, thereby improving living standards.*
- *Deficit elimination, low inflation, trade liberalization, reforms of transfer programs and employment insurance (EI), and government support for skills development, education and new technologies, are designed to increase the rate of productivity growth and boost employment.*

Measuring living standards.

$$\frac{\text{Real GDP}}{\text{Population}} = \frac{\text{Real GDP}}{\text{Employment}} \times \frac{\text{Employment}}{\text{Population}}$$

The most commonly used measure of living standards is real (inflation-adjusted) gross domestic product divided by the size of the population.

- Real GDP is a measure of all goods and services produced in the country in a year.
- Equivalently, real GDP measures the amount of income generated in Canada during a year, including wages and salaries, business profits and earnings from self-employment.

Real GDP per capita is the product of two key variables:

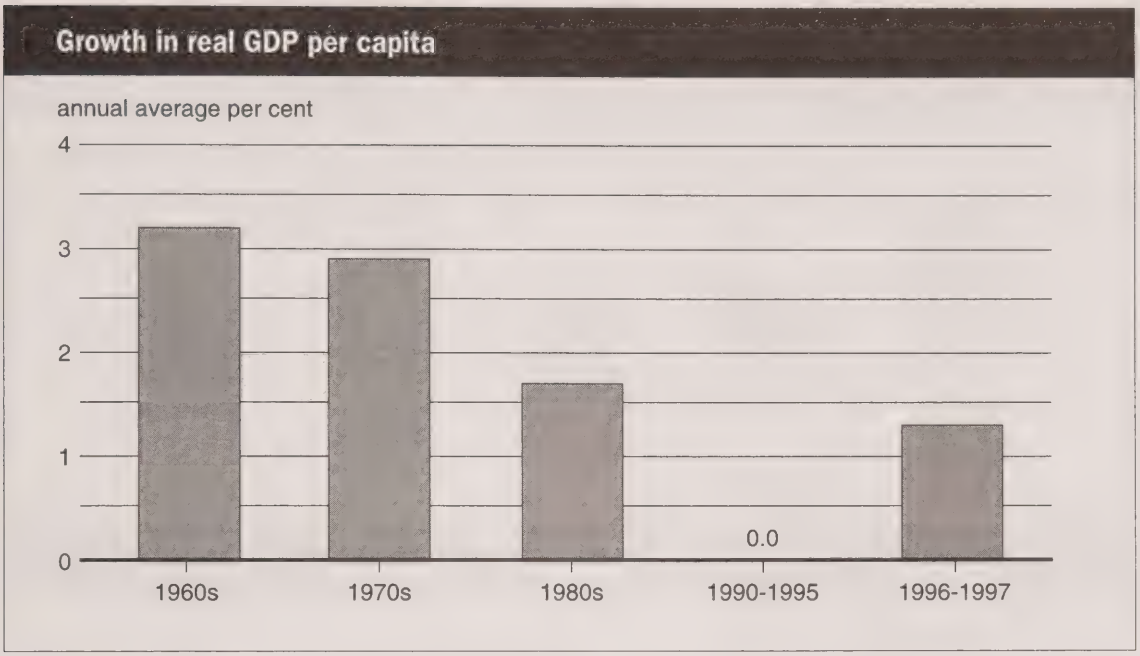
- the average value of goods and services produced by each person working (the productivity level); and
- the proportion of the population that is working (the employment rate).

The higher the productivity level of each worker and the larger the share of the population that is working, the higher real GDP per capita will be, everything else equal.

Thus, living standards can be improved:

- by increasing average labour productivity; and
- by increasing the employment rate.

Growth in real GDP per capita has slowed in recent decades.



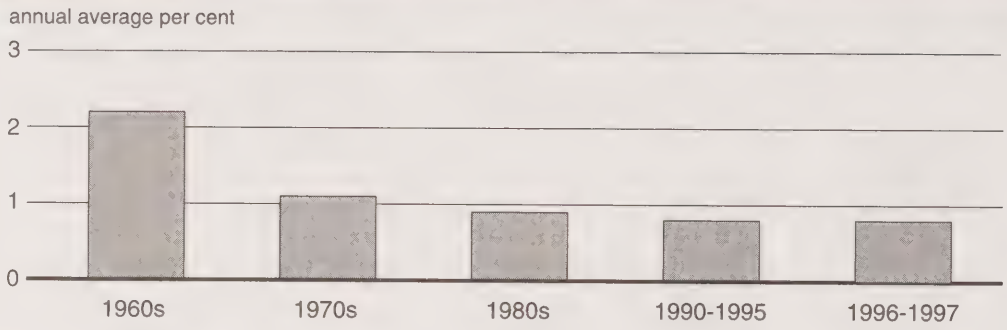
Source: Statistics Canada.

What has happened to real GDP per capita in Canada over the last few decades?

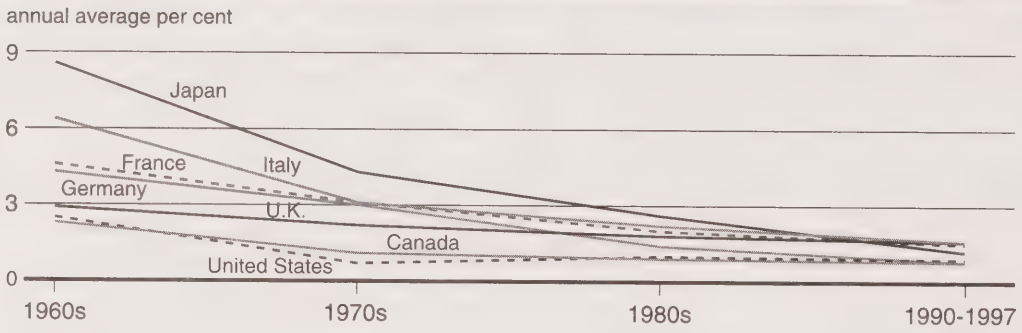
- In the 1960s and 1970s, real output per capita grew rapidly.
- However, growth in real GDP per capita has slowed noticeably since the end of the 1970s.
- In the first half of the 1990s, real GDP per capita failed to grow at all, although there has been some improvement in the last two years.

The growth of labour productivity has slowed in Canada and throughout the industrialized world.

Growth of labour productivity in Canada



Growth of labour productivity in G-7 countries

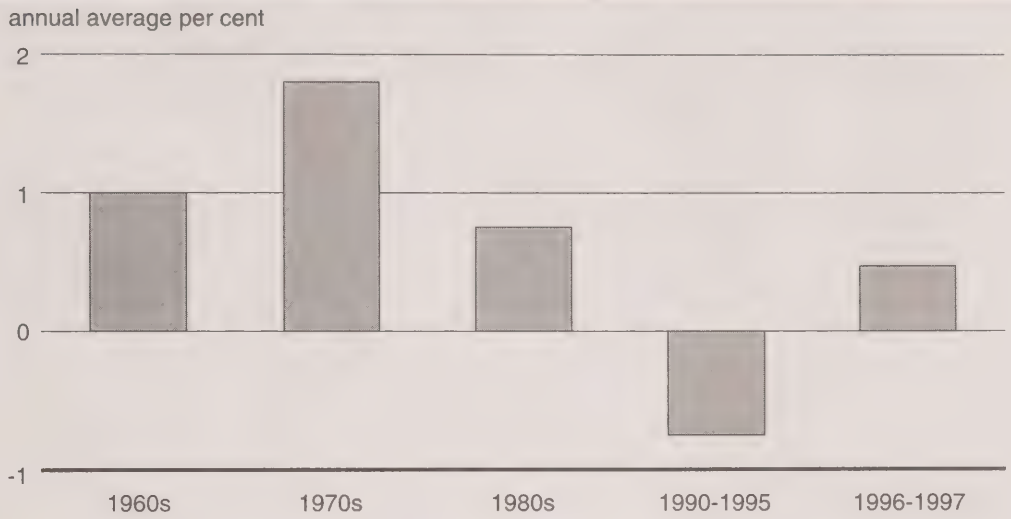


Sources: Statistics Canada, OECD.

- Labour productivity growth in Canada has slowed from over 2 per cent per year in the 1960s to less than 1 per cent in both the 1980s and so far this decade.
- Canada was not alone in experiencing a slowdown in the growth of labour productivity. Every major industrialized country has experienced a similar or even greater slowing of productivity growth. Nonetheless, throughout the 1980s and most of the 1990s, Canada has recorded the lowest rate of productivity growth among the Group of Seven (G-7) countries.

The employment rate fell over the first half of the 1990s but has recently begun to rise again.

Change in the employment rate

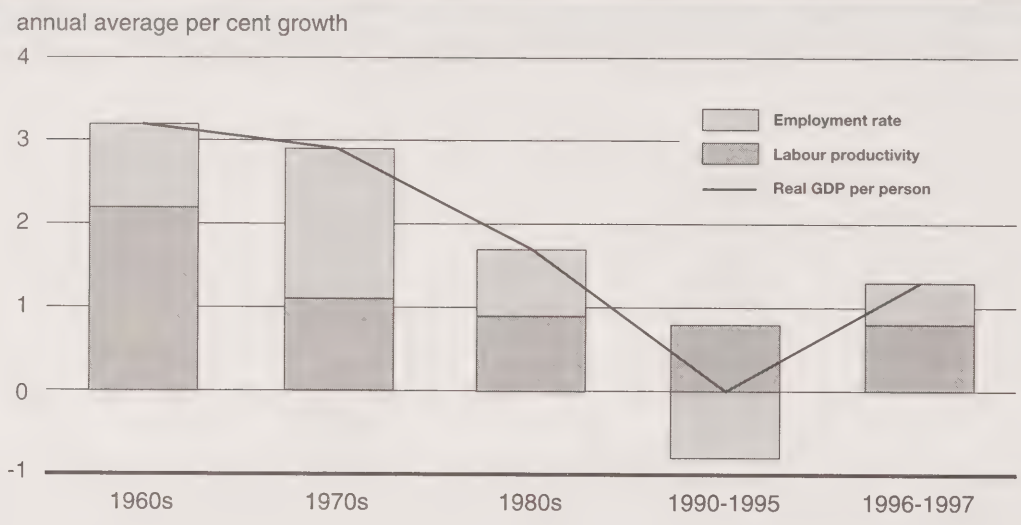


Source: Statistics Canada.

- The employment rate is sensitive to structural factors such as the age structure of the population, the average length of schooling and the customary retirement age. It is also subject to the business cycle, falling when the economy is weak and rising when it is strong.
- During the 1960s, 1970s and into the 1980s, large numbers of young baby boomers were entering the workforce. As well, more women were taking jobs. Both trends pushed up the employment rate, boosting growth in real GDP per capita.
- In the 1990s, however, there are fewer young people coming into the workforce, the female employment rate is no longer rising rapidly, youth have been staying in school longer, and there has been a rising trend towards early retirement. In addition, the labour market has been generally weak. These factors have all worked to depress the employment rate which fell over the first half of the decade.
- As the economy has strengthened over the last few years, rising employment has led to a pickup in the employment rate. This is expected to continue over the next several years, and the employment rate is expected to rise modestly in the next decade.
- However, the bulk of the baby boom will retire in the next 25 years which could push the employment rate down substantially, starting from about 2005 and accelerating from about 2010.
- With the impending retirement of the baby boom, the employment rate cannot be expected to rise to support growth in real GDP per capita. This means that higher productivity growth is essential to ensure higher living standards for Canadians.

Combining productivity growth and the employment rate.

Explaining growth of real GDP per capita



Source: Statistics Canada.

Together, the pattern of slowing labour productivity growth and fluctuations in the employment rate explain the slowing of growth of real GDP per capita since the 1960s.

- In the 1960s, with both rapid productivity growth and a rising employment rate, real GDP per capita grew rapidly.
- In the 1970s, slowing productivity growth was partially masked by a sharp increase in the employment rate so that real GDP per capita continued to rise rapidly.
- However, in the 1980s, productivity growth slipped somewhat further and growth in the employment rate was significantly reduced. As a result, real GDP per capita grew only about half as fast as in the earlier decades.
- In the first half of the 1990s, continued modest productivity growth was negated by a fall-off in the employment rate and, as a result, real GDP per capita stagnated.
- In the last few years, a pickup in the employment rate and continued modest productivity growth have led to renewed growth in real GDP per capita.
- Productivity growth and employment levels are influenced by a wide range of policies. No single policy initiative can, by itself, dramatically speed the growth in Canadians' living standards. What is required is action in a broad range of areas.
- The payoff from a concerted strategy of supporting productivity growth and employment will be a better standard of living for all Canadians.

Government policies to promote higher living standards.

Policy area	Channels	Accomplishments
Fiscal and monetary policy	A stable macroeconomic environment with low inflation brings lower interest rates and boosts confidence, encouraging investment which enhances productivity growth and boosts employment	Federal deficit eliminated Debt-to-GDP ratio on a clear downward path Substantial fiscal progress at the provincial government level Low inflation record of 1990s
Tax policy	Taxes can affect the allocation of resources and alter the incentives to work, save and invest	Beginning of general tax relief National Child Benefit System to support working parents HST to reduce compliance costs
Support for education and skills development	Gets more people into the workforce, boosting the employment rate. Helps people get higher productivity, higher wage jobs	Canadian Opportunities Strategy Canada Millennium Scholarships Canada Study Grants and tax relief for interest on student loans Canada Education Savings Grants Increased education and tuition tax credits SchoolNet to give young students Internet access Increased funding for youth at risk who lack basic education and job skills
Support for R&D	Provides the innovation needed to improve production processes, boosting productivity	Canada Foundation for Innovation Technology Partnerships Canada Tax support for R&D Networks of Centres of Excellence
Social and labour market policies	Influences work incentives Can facilitate workforce participation by removing barriers	EI reform
Trade policy	Increases competition and allows countries to specialize in products they are good at making, boosting productivity and competitiveness	NAFTA Leading player in WTO Ongoing efforts to ensure the free flow of goods and services within Canada
Letting the market work	Regulation and subsidies can dampen market signals and distort the allocation of resources, inhibiting productivity growth Privatization can enhance competition and boost productivity	Reduced business and transportation subsidies Partial or full privatization of Air Canada, Petro Canada, Canadair, De Havilland Canada and CN

5

Building a Strong Foundation for the Canadian Dollar

Highlights

"But it is the structural problems that were allowed to fester over a period of 25 years that have caused its [the Canadian dollar's] long-term decline."

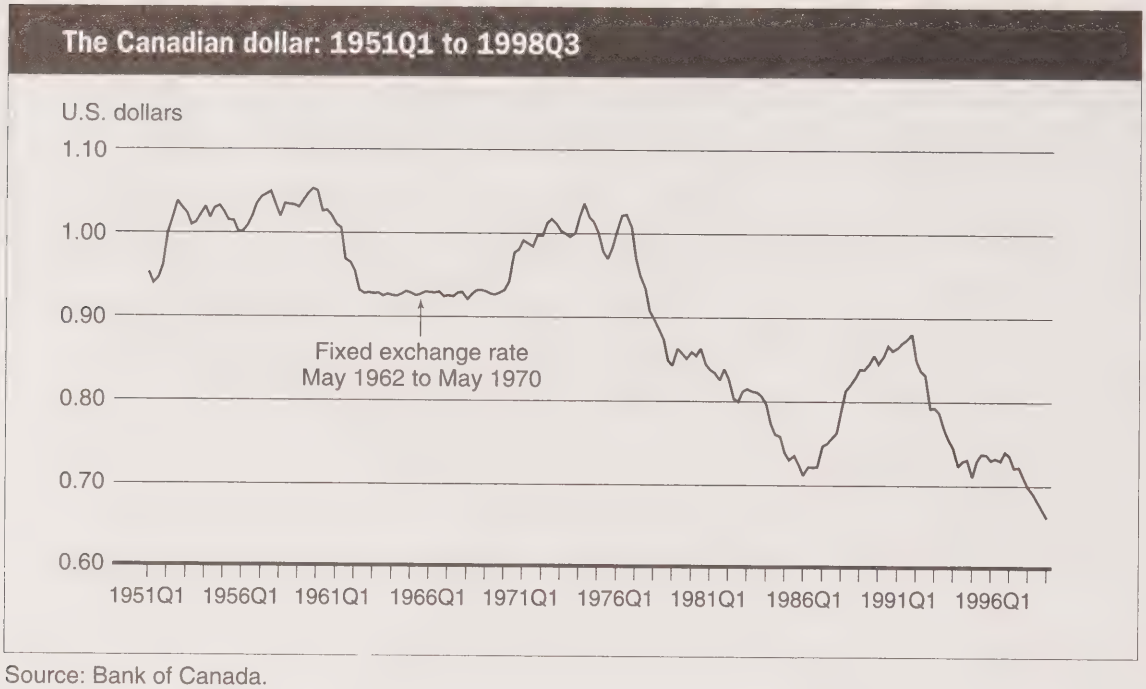
"The markets have an image of the Canada of yesterday, not the Canada of today."

"This reality is Canada: more diversified, more sophisticated and anchored in a much sounder financial footing than it has been for decades."

The Honourable Paul Martin
Minister of Finance

- *Economic and policy developments both in Canada and in our trading partners influence the external value of the Canadian dollar.*
- *The weakness in the dollar over the past year, punctuated by a series of record lows against the U.S. dollar in August, reflects external developments: sharp declines in world commodity prices and the international financial market volatility stemming from the financial crises in Asia and Russia that boosted the U.S. dollar relative to all currencies.*
- *In contrast with the U.S. and other Group of Seven (G-7) countries, Canada is a net exporter of commodities. When commodity prices fall, our net exports fall and so does the value of the Canadian dollar.*
- *But foreign exchange markets may have overlooked the changes in the Canadian economy.*
- *Canada's dependence on commodity-based exports has steadily declined from 60 per cent less than 20 years ago to 35 per cent.*
- *And action has been taken to deal with the problems that contributed to the weakening of the dollar in the past such as poor inflation performance in the 1970s and 1980s, chronic government deficits and growing public debt.*

The historical evolution of the dollar.



Source: Bank of Canada.

- From the 1950s to the mid-1970s, which includes the period from May 1962 to May 1970 when the exchange rate was pegged, the Canadian dollar was relatively stable and remained close to parity with the U.S. dollar.
- From the mid-1970s to the mid-1980s, the dollar steadily drifted downward from just under $1.04 U.S. in June 1976 to a then-record low of 69.13 U.S. cents in February 1986. This downward trend reflected a number of factors: falling real commodity prices; deteriorating fiscal positions in Canada; and increasing inflation in Canada relative to the U.S.
- From the low in 1986, the dollar temporarily appreciated to over 89 U.S. cents in November 1991. This appreciation was due to Canadian interest rates rising sharply above U.S. rates to reduce inflation and rising commodity prices.
- As the interest rate differential narrowed and the U.S. economy recovered more rapidly than the Canadian economy, the dollar drifted back down. By April 1994, the dollar had moved down to the 72-U.S.-cent range.
- From early 1994 to late 1997, the dollar was relatively stable, trading in the 71- to 75-U.S.-cent range.
- Over the summer, as the Asian and Russian financial crises deepened, the dollar moved down through a series of new lows to a record closing low of 63.31 U.S. cents on August 27, before rebounding in September.

Factors influencing the Canadian dollar.

Long-term structural factors

- Terms of trade (commodity prices)
- Canada's economic performance and policies relative to trading partners

In general, these factors exert a strong influence on the longer-term trend movements in the exchange rate.

Some of these factors are beyond Canada's control, such as movements in our terms of trade (driven principally by swings in commodity prices) and economic performance and policies in our major trading partners.

Canadian economic and financial performance is an important factor influencing the exchange rate. This includes inflation, unit labour cost growth, government deficits, public debt and the current account balance.

Short-term factors

- Interest rates
- Investor confidence (domestic policy, political developments and uncertainty)
- Safe-haven effects (international market volatility)

The short-term macroeconomic policy stance in Canada can exert a strong influence on the Canadian dollar. The exchange rate, for example, is affected by changes in the short-term interest rate differential with the U.S.

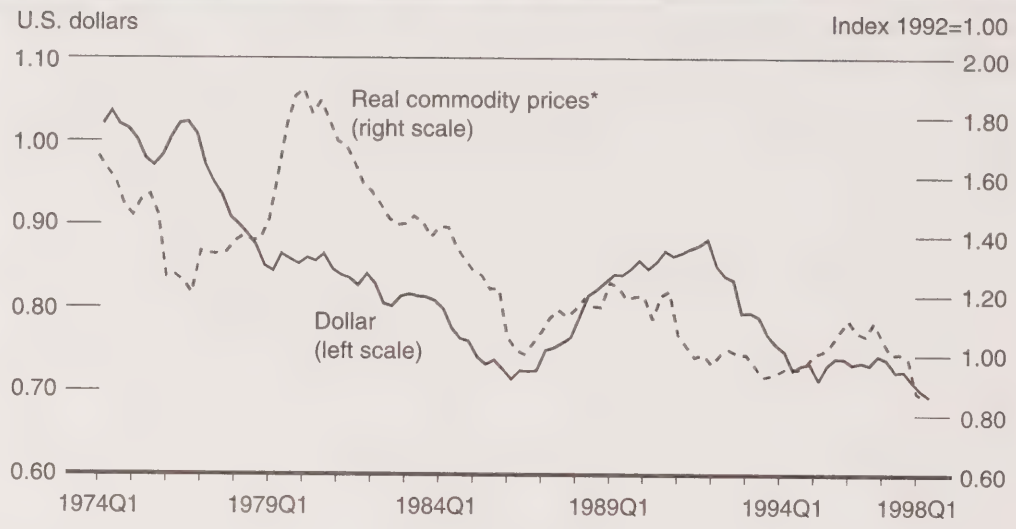
A tightening of Canadian monetary conditions that raises Canadian interest rates relative to those in the U.S. tends to cause the dollar to rise. As well, expectations of changes in the policy stance can also bring about immediate changes in the exchange rate.

Confidence and safe-haven effects can also be important factors for the exchange rate. Investor sentiment towards a country's currency can swing in response to both domestic and international economic and policy developments and political uncertainty.

For example, the U.S. dollar typically strengthens during periods of financial market turbulence as it has with the Asian and Russian financial crises.

Real commodity prices are a key factor in the evolution of the dollar.

Relationship between dollar and commodity prices



Sources: Department of Finance and Bank of Canada.
*U.S. dollar Commodity Price Index deflated by U.S. GDP deflator.

- The trend decline in the exchange rate from the 1970s to mid-1980s is partly explained by a corresponding decline in the real price of commodities.
- The recent depreciation of the Canadian dollar largely reflects the impact on Canadian exports and export earnings of falling world commodity prices, compounded by international financial market turbulence due to developments in Asia and, more recently, Russia.
- The magnitude of the recent commodity price decline is striking. Commodity prices have fallen about 28 per cent since their peak at the end of 1996. Real commodity prices have drifted down since the early 1970s. In real terms, they are now close to their lowest level since the early 1970s.

Canada is an important net exporter of commodities.

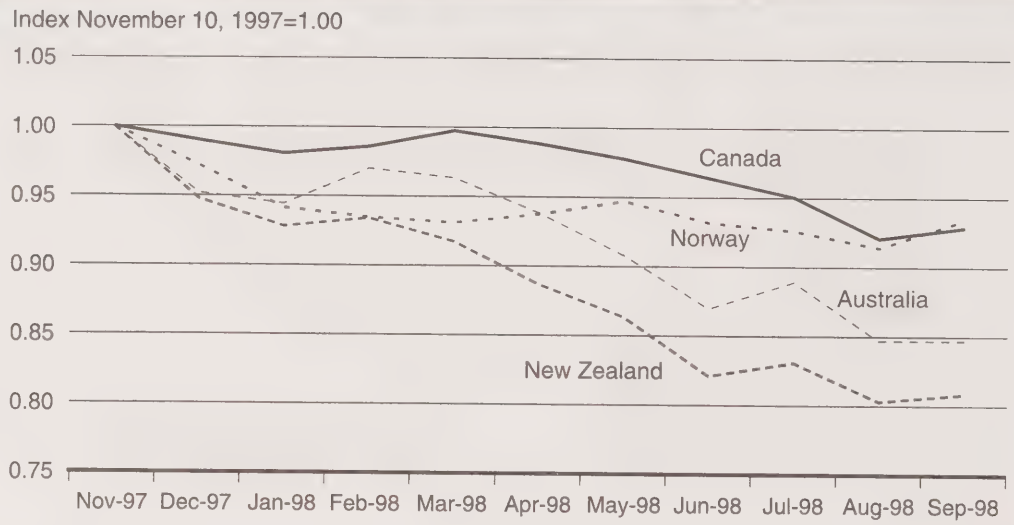


Source: Statistics Canada and U.S. Bureau of Census.

- Canada is an important net exporter of commodity-based products to the rest of the world. In 1997, Canada had a net surplus on commodity trade of about 7 per cent of gross domestic product (GDP) or $62 billion.
- Accordingly, movements in commodity prices have a significant impact on the Canadian economy. In general, when commodity prices rise, so too does our trade balance. And when commodity prices fall, our net exports fall as well. Because the exchange rate adjusts to equilibrate trade and capital flows in a flexible exchange rate system, this implies that rising commodity prices are associated with an appreciation of the dollar and vice versa.
- In contrast, the United States and the other G-7 countries are net importers of commodity-based products. For example, in 1997, the United States had a deficit on commodity trade equivalent to about 0.8 per cent of GDP or $66 billion.
- As a result, their currencies tend to strengthen when commodity prices decline as the decline in the value of their exports is more than offset by the lower costs of their imports.

Currencies of other commodity exporters have depreciated.

Recent currency movements relative to the U.S. dollar

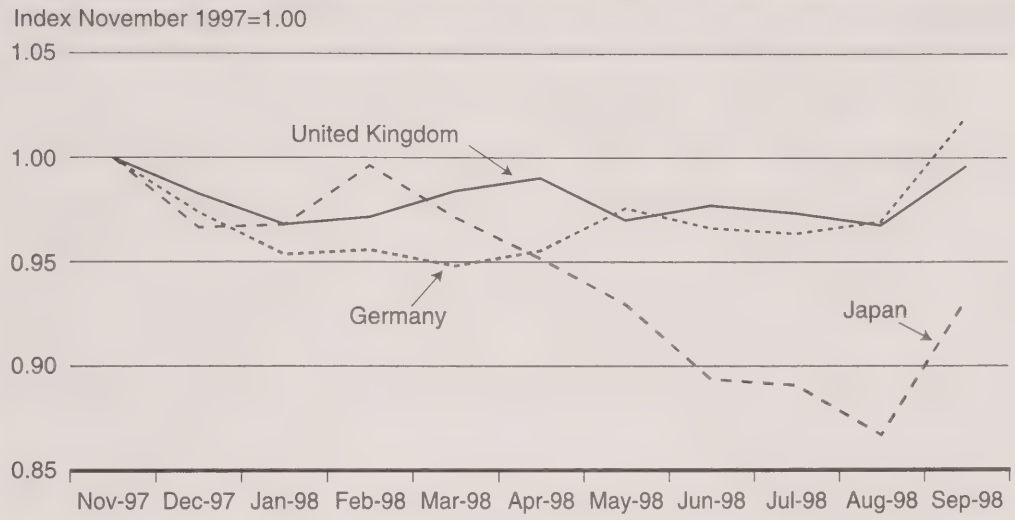


Source: Federal Reserve Board.

- The currencies of countries that are net exporters of commodity-based products have depreciated relative to the U.S. dollar.
- The currencies of Australia and New Zealand – which are both highly dependent on commodity exports and Asian demand for their exports – have lost considerably more value than has the Canadian dollar. From last November to the end of September, these countries' currencies have declined more than 15 per cent against the U.S. dollar. Over the same period, the Canadian dollar dropped about 7 per cent.
- Similarly, the Norwegian krone has declined sharply against the U.S. dollar. This has occurred despite the Norwegian central bank raising key interest rates seven times so far in 1998, for a cumulative increase of 450 basis points – 300 basis points in August alone.

The American dollar has been strong against other G-7 currencies.

Recent currency movements relative to the U.S. dollar

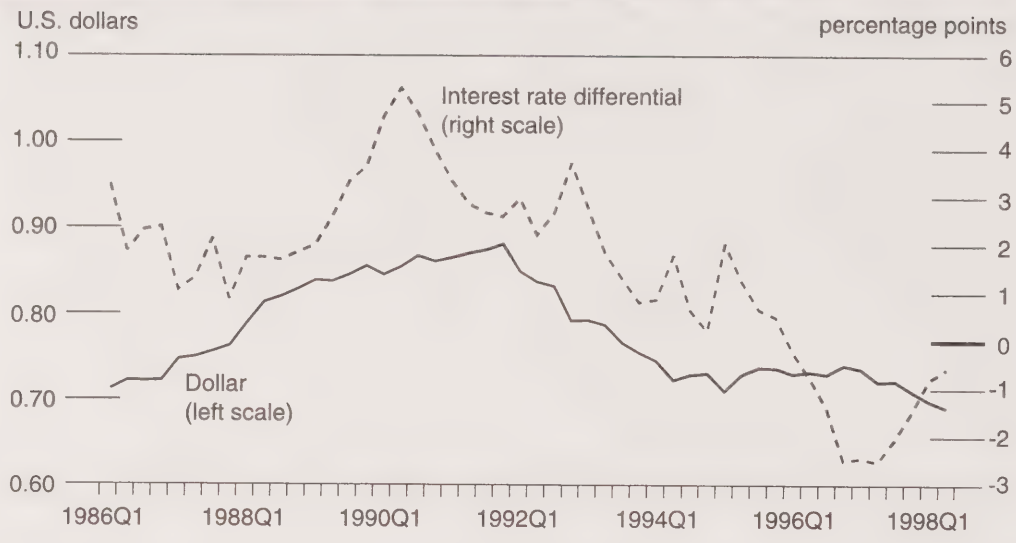


Source: Federal Reserve Board.

- The currencies of the European economies, which are net importers of commodities, have been comparatively stable relative to the U.S. dollar.
- But even these countries saw their currencies decline.
- The Asian financial and economic crisis and, more recently, the developments in Russia have led investors to seek "safe havens" in U.S.-dollar-denominated assets.
- Until very recently, this has tended to boost the U.S. dollar relative to all currencies, including European currencies.

The dollar is also affected by interest rates in the short term.

The dollar and Canada-U.S. short-term interest rate differentials



Source: Bank of Canada.

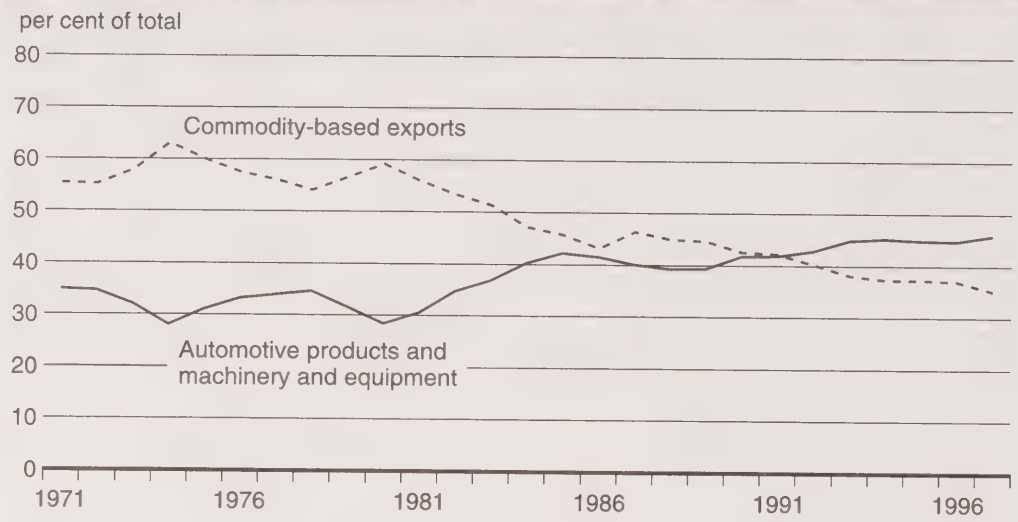
- However, commodity prices are not the whole story; other factors also affect the exchange rate. On a number of occasions, the dollar has moved in the opposite direction to commodity prices for an extended period of time, especially in the 1970s and early 1980s.
- The short-term policy stance and interest rate differentials have also been an important influence on the dollar during certain periods. They are readily apparent in the movements in the dollar in the late 1980s and early 1990s.
- The dollar appreciated significantly in the late 1980s and early 1990s following very steep increases in Canadian interest rates, which took them to 5 percentage points above U.S. rates. Rising commodity prices also contributed to the dollar's strength at that time.
- In contrast, by late 1996, when it was clear that the government's commitment to reverse the steady erosion of our public finances was paying off, Canadian interest rates were well below comparable U.S. rates while the appreciation of the dollar had abated.

The Canadian economic and policy environment that undermined the dollar in the past has changed for the better.

- While commodity prices have played a role in the decline in the external value of the Canadian dollar over the past 20 years or so, our economy has evolved and our reliance on commodity-based exports has declined significantly.
- Other structural factors that undermined the dollar in the past have been turned around.
- From the mid-1970s to late 1980s, higher rates of growth of prices and production costs in Canada than in the United States put downward pressure on the dollar.
- The run-up in government deficits and debt in Canada that began in the early 1970s undermined investor confidence and weakened the dollar.
- In addition, government deficits contributed to the widening of the current account deficit, adding to the downward pressure on the dollar.
- These long-term structural factors have been turned around: Canada has become a low inflation country; the government deficit has been eliminated; and the debt-to-GDP ratio is on a clear downward track.
- This combination of economic and policy achievements provides a strong foundation for the dollar.
- Indeed, 18 months ago, most analysts saw these achievements underpinning a strengthening of the dollar in the months and years ahead.
- These underlying strengths remain.

The diversification of the Canadian economy is ongoing.

Canadian exports of commodities and machinery, equipment and automobiles

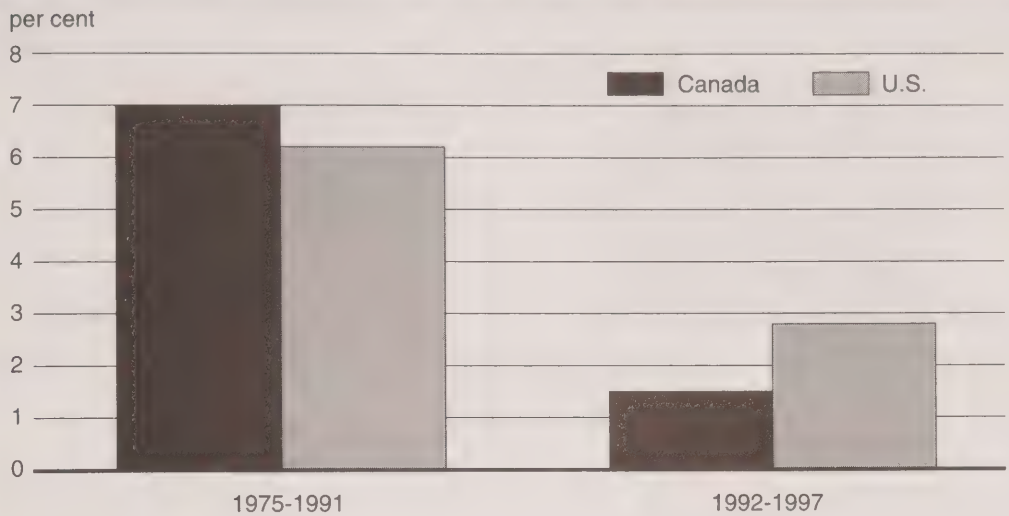


Source: Statistics Canada.

- The ongoing diversification of the Canadian economy is reflected in the declining share of commodity exports and the rising share of manufactured product exports.
- The share of commodity exports in Canada's exports has declined from about 60 per cent in 1980 to about 35 per cent in 1997.
- Automotive products and machinery and equipment each account for about one-quarter of Canada's merchandise exports. Since 1992, exports of these manufactured products have exceeded exports of commodities.
- In the 1990s, the high-tech sector in Canada has posted output and job growth that was double the rate in the rest of the economy.
- Canada's declining reliance on commodity-based exports is sometimes overlooked. This is consistent with a recent OECD study which found that the Canadian dollar was undervalued by a wide margin.

Canada is a low inflation country.

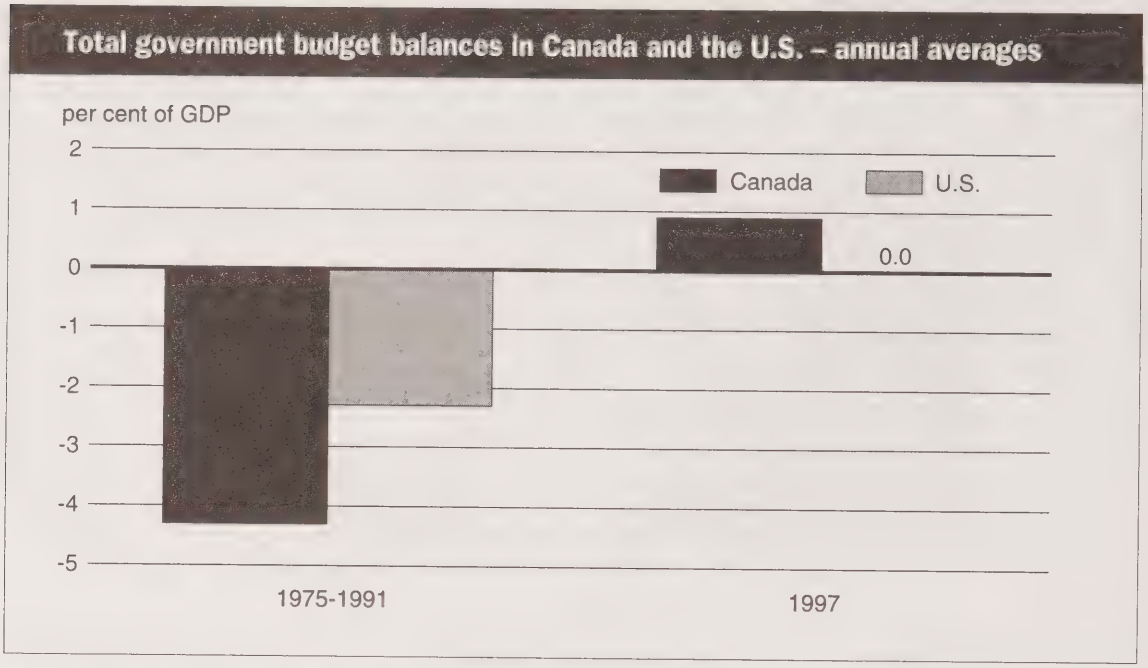
Average annual CPI inflation in Canada and the U.S.



Sources: Statistics Canada and U.S. Bureau of Labour Statistics.

- For years, Canadian inflation was generally above U.S. inflation; for the last five years, it is consistently below U.S. inflation.
- From 1975 to 1991, Canada's annual inflation rate exceeded the U.S. rate by almost 1 percentage point on average.
- The more rapid growth in prices and costs in Canada eroded Canada's competitiveness and weakened the dollar.
- Since 1992, price and cost inflation in Canada has been well below that in the U.S.
- Further, Canada has had the second lowest inflation rate among the G-7 countries over this period.
- Canada's strong inflation performance has made a significant contribution to Canada's international competitiveness.

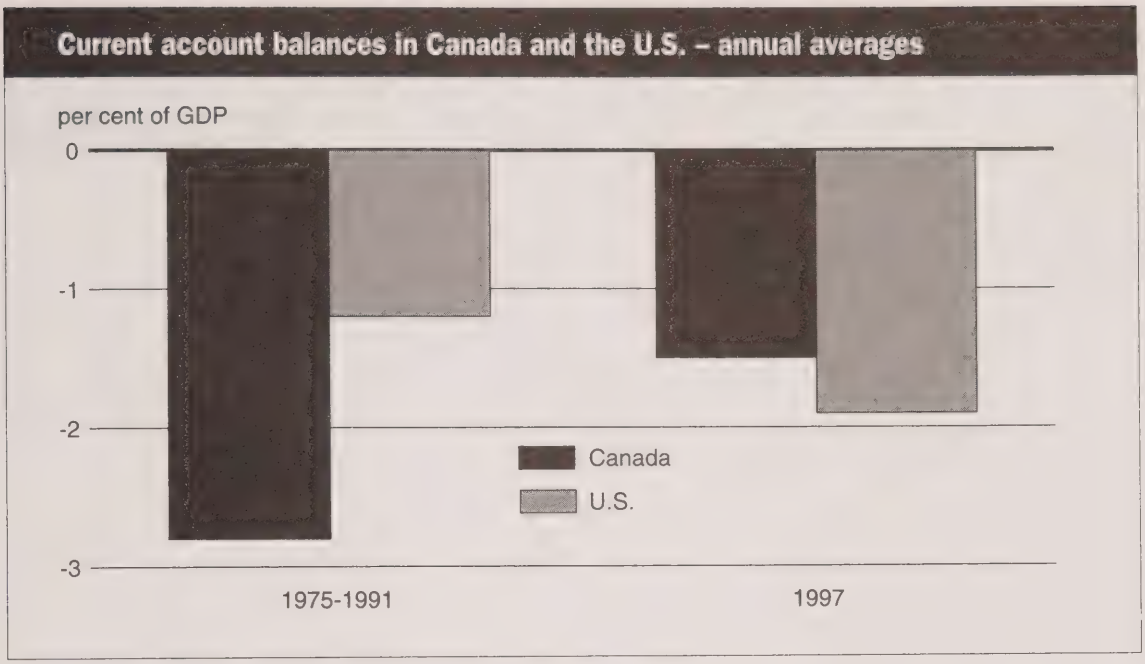
The federal government's deficit has been eliminated and the total government sector has moved into surplus.



Sources: Statistics Canada and OECD.

- In the 1970s and 1980s, government deficits were much larger in Canada than the U.S. Last year, while the overall government sector in the U.S. just managed to balance its books, we were already in surplus on a national accounts basis.
- The federal government deficits of the 1970s, 1980s and early 1990s were reflected in rising public debt.
- That debt is now being paid down.

Fiscal surpluses will lessen Canada's reliance on foreign savings.



Sources: Statistics Canada and U.S. Bureau of Economic Analysis.

- Canada's government deficits in the 1970s and 1980s increased Canada's reliance on foreign savings, widening the current account deficit.
- Canada's current account deficit was, on average, more than twice as large as that in the U.S. from the mid-1970s to early 1990s.
- These deficits, in turn, contributed to a weaker Canadian dollar.
- The swing to surplus in the government sector's financial situation will contribute to reducing Canada's reliance on foreign savings.

6

Canada's Economic Performance in the G-7

Highlights

"In the fall of 1993, the unemployment rate was 11.4 per cent. Today, while still too high, it is at 8.3 per cent, its lowest level in eight years, a track record of improvement exceeded only by the U.K. among the G-7 nations."

"Inflation is under firm control and will remain so. Indeed, Canada now enjoys a solid reputation as a low inflation country."

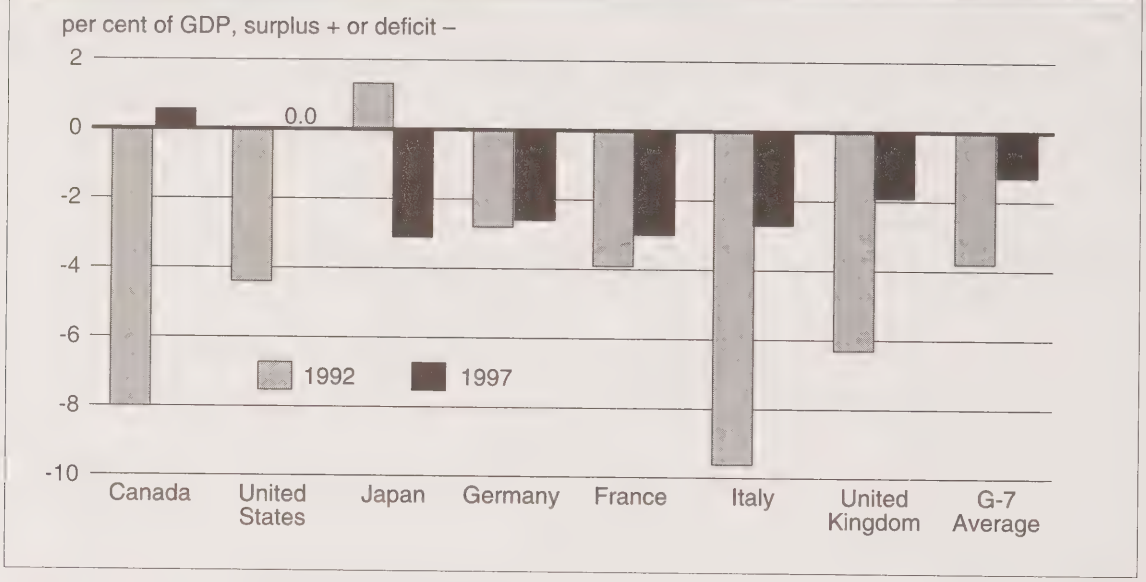
"... the major international institutions – the IMF and the Organization for Economic Co-operation and Development, the OECD – expect Canada's economic and employment growth this year to be among the best of the major industrial nations."

The Honourable Paul Martin
Minister of Finance

- *Canada's fiscal and economic performance compares very favourably with that of other Group of Seven (G-7) countries since the early 1990s.*
- *Canada has taken the necessary measures to put its fiscal house in order. As a result, in 1997, Canada was the only country in the G-7 to post a surplus.*
- *Canada has gained an international reputation as a low inflation country.*
- *Canada is the most trade-oriented country in the G-7.*
- *As a result of sound economic policies, Canada's economic performance is now among the best in the G-7.*
- *Employment growth in Canada averaged 1.7 per cent over the 1993-1997 period, the second highest in the G-7.*
- *Moreover, the International Monetary Fund (IMF) expects Canada's employment growth to average 2 per cent in 1998 and 1999, the best performance in the G-7.*
- *Key challenges for Canada are to improve productivity growth and reduce its reliance on foreign savings.*

Canada has made the strongest fiscal improvement in the G-7.

Total government financial balances
(national accounts basis)

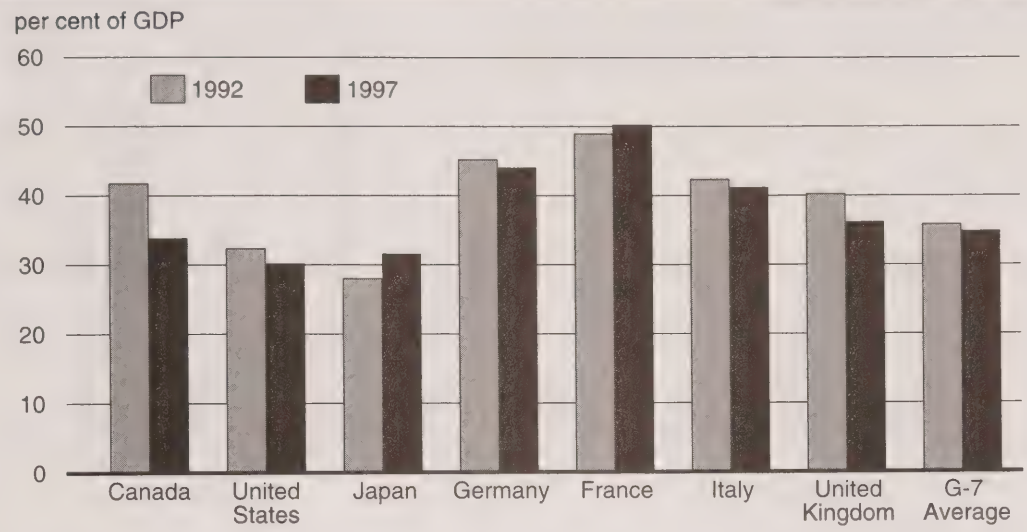


Source: OECD Economic Outlook, June 1998.

- Unco-ordinated macroeconomic policies in the late 1980s and early 1990s led to a substantial deterioration in Canada's public finances.
- In 1992, Canada had the second highest deficit as a per cent of gross domestic product (GDP) in the G-7.
- However, Canada responded to the fiscal challenge and took the necessary measures to put its fiscal house in order. As a result, in 1997, Canada was the only country in the G-7 that posted a surplus.
- The federal government has been paying down market debt since early 1997.
- In 1997-98, for the first time since 1969-70, the federal government reduced the absolute level of its debt.
- Indeed, Canada has made the strongest fiscal improvement in the G-7.

Canada has recorded the largest reduction in program spending in the G-7.

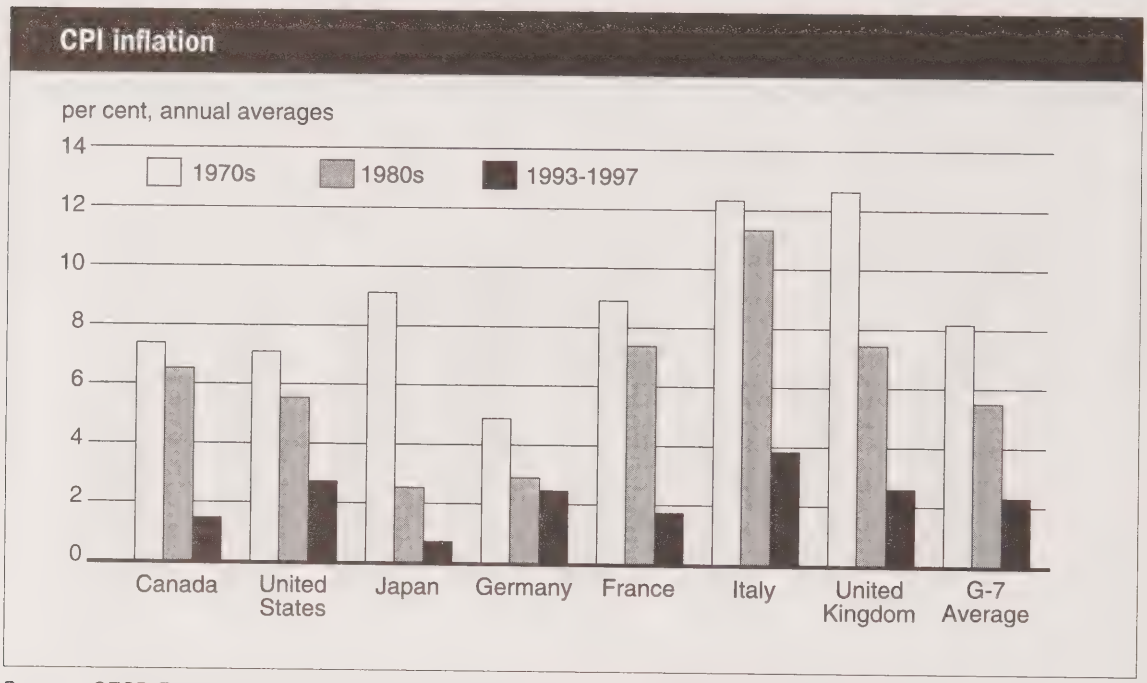
Total government program spending
(national accounts basis)



Source: OECD *Economic Outlook*, June 1998.

- Sharp reductions in program spending were the major factor underlying Canada's fiscal improvement.
- In fact, Canada's program spending has fallen much faster than in other G-7 countries.
- Between 1992 and 1997, Canada's total government program spending was reduced from 41.7 per cent to 33.8 per cent of GDP, a reduction of about 8 percentage points. Over the same period, program spending in the G-7 countries declined by only 1 percentage point on average, from 35.8 per cent to 34.8 per cent of GDP.
- As a result, Canada's program spending in relation to the size of its economy is now lower than the G-7 average.

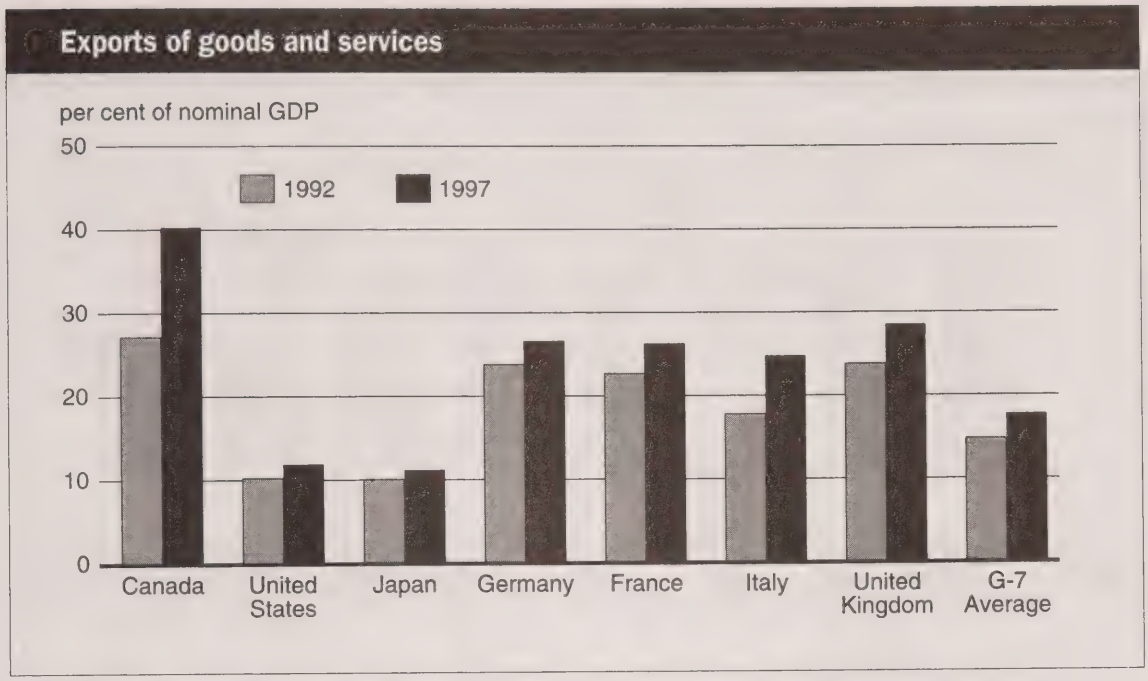
Canada has gained an international reputation as a low inflation country.



Sources: OECD *Economic Outlook*, June 1998; *International Financial Statistics Yearbook*, 1997.

- There has been much success in lowering inflation in all the G-7 countries. In fact, inflation in most countries has fallen to levels not seen in decades.
- In that favourable international context, Canada's inflation averaged less than 2 per cent over the past few years, the second lowest in the G-7. This is substantially lower than its inflation in the 1970s and 1980s which was above that in the U.S.

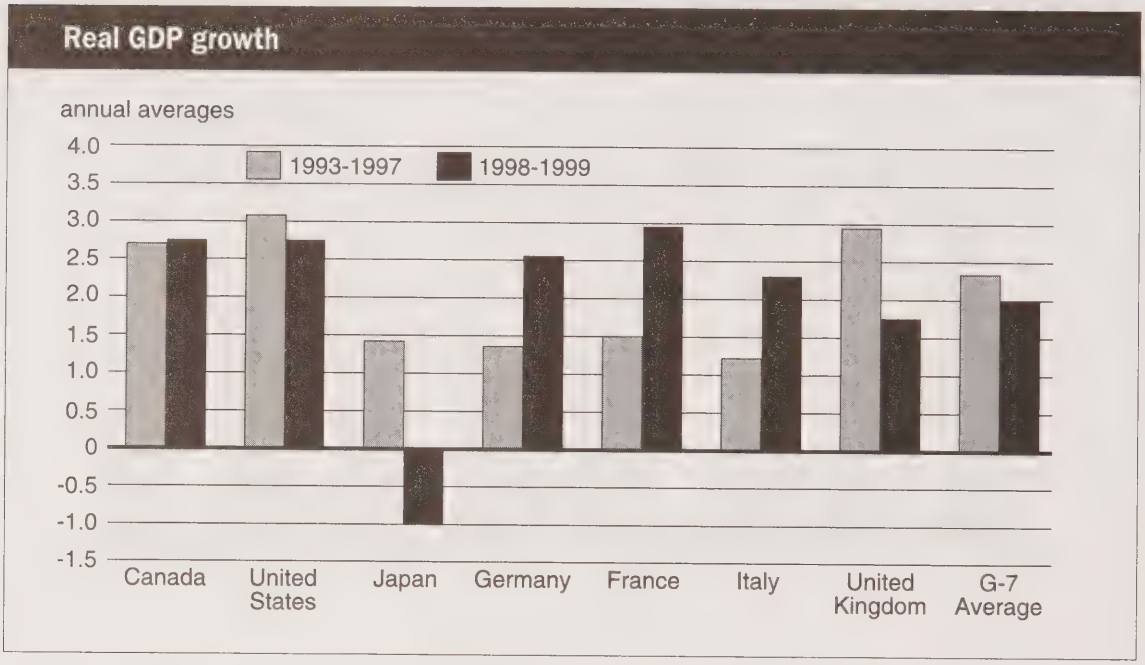
Canada is the most trade-oriented country in the G-7.



Source: OECD *Economic Outlook*, June 1998.

- Trade constitutes a significant portion of economic activity in Canada. That portion has been growing rapidly over the past few years owing to the success of recent trade initiatives and the successful completion of multilateral trade negotiations.
- The share of exports in total economic activity has recently risen in all the G-7 countries with Canada posting the largest increase, from 27 per cent in 1992 to just over 40 per cent in 1997.
- Canada's exports as a share of GDP are now more than twice as high as the G-7 average.

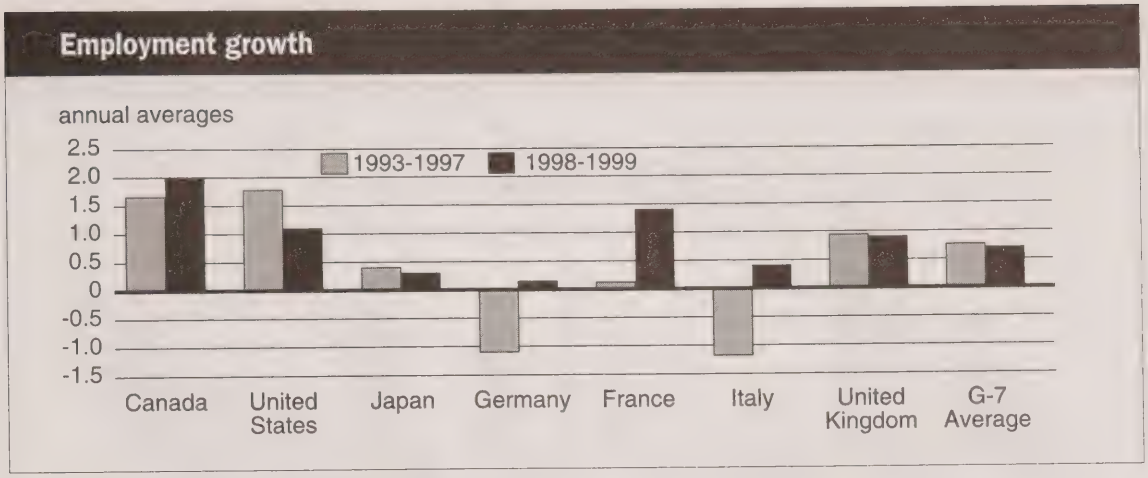
Sound economic policies have made Canada a top performer in the G-7 in terms of economic growth.



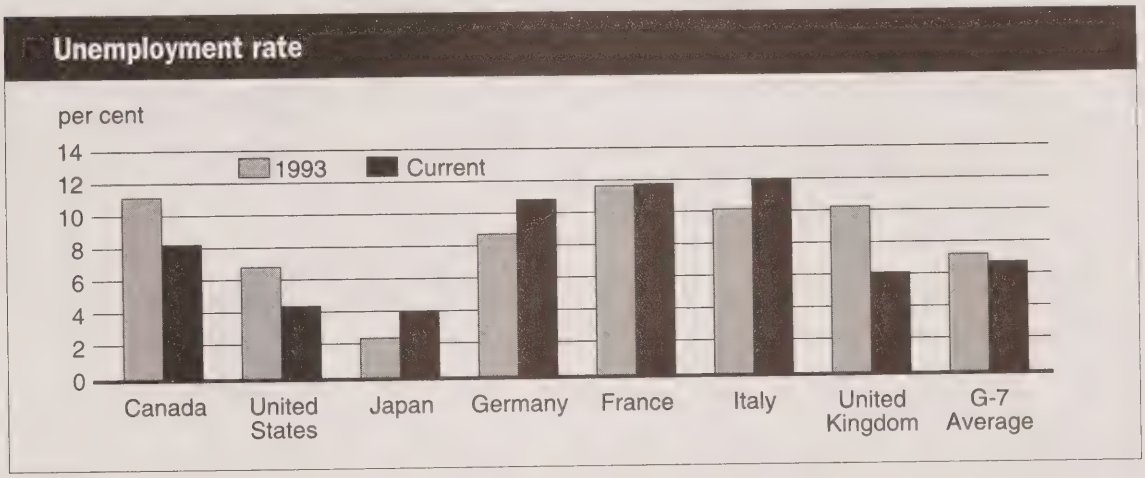
Source: IMF *World Economic Outlook*, October 1998.

- Canada's economic growth has picked up over the past few years from its poor performance in the early 1990s.
- Real GDP growth averaged 2.7 per cent over the 1993-1997 period, bettered only marginally by the U.S. and the U.K.
- Moreover, Canada's growth performance is expected to remain favourable. The IMF projects Canada's growth to average 2.8 per cent in 1998 and 1999, among the top performances in the G-7.

Canada's job creation is among the best in the G-7.



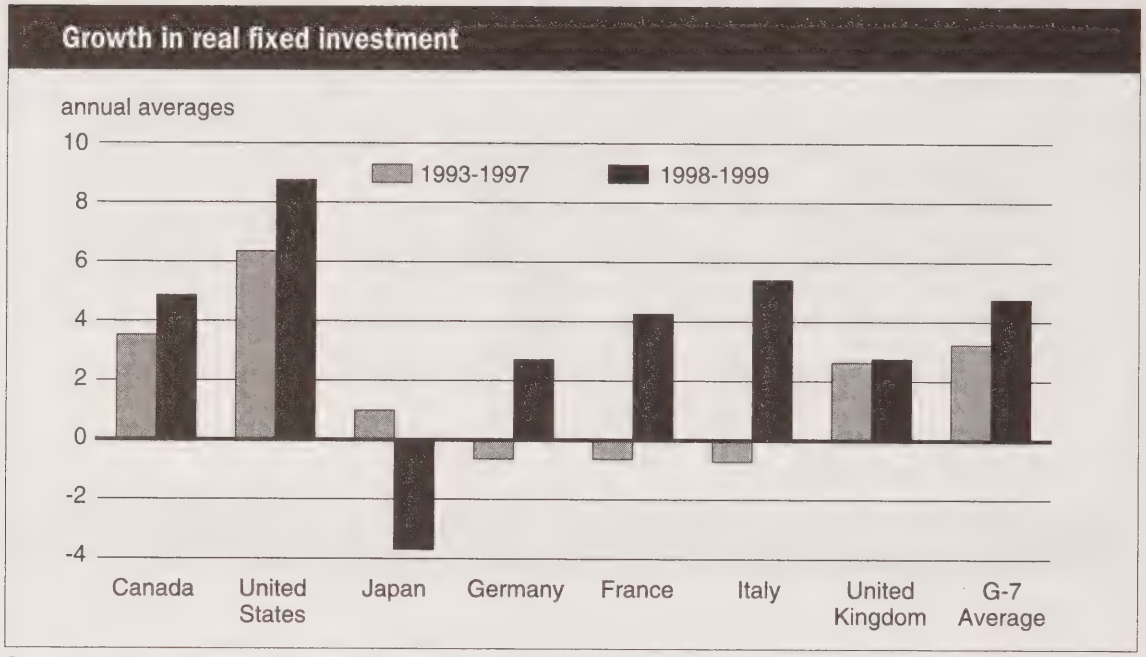
Source: IMF *World Economic Outlook*, October 1998.



Source: DRI

- Improving economic activity is boosting employment growth and reducing the unemployment rate. Canada has been a top performer in the G-7 in this regard.
- Employment growth in Canada averaged 1.7 per cent over the 1993-1997 period, the second highest in the G-7 after the United States. Moreover, the IMF expects Canada's employment growth to average 2 per cent in 1998 and 1999, the best performance in the G-7.
- While the unemployment rate still remains too high in Canada, it has declined significantly in recent years – at 8.3 per cent in August, the unemployment rate is at its lowest level in eight years. Indeed, Canada's unemployment rate has fallen by nearly 3 percentage points since 1993, the second largest decline in the G-7 after the United Kingdom.

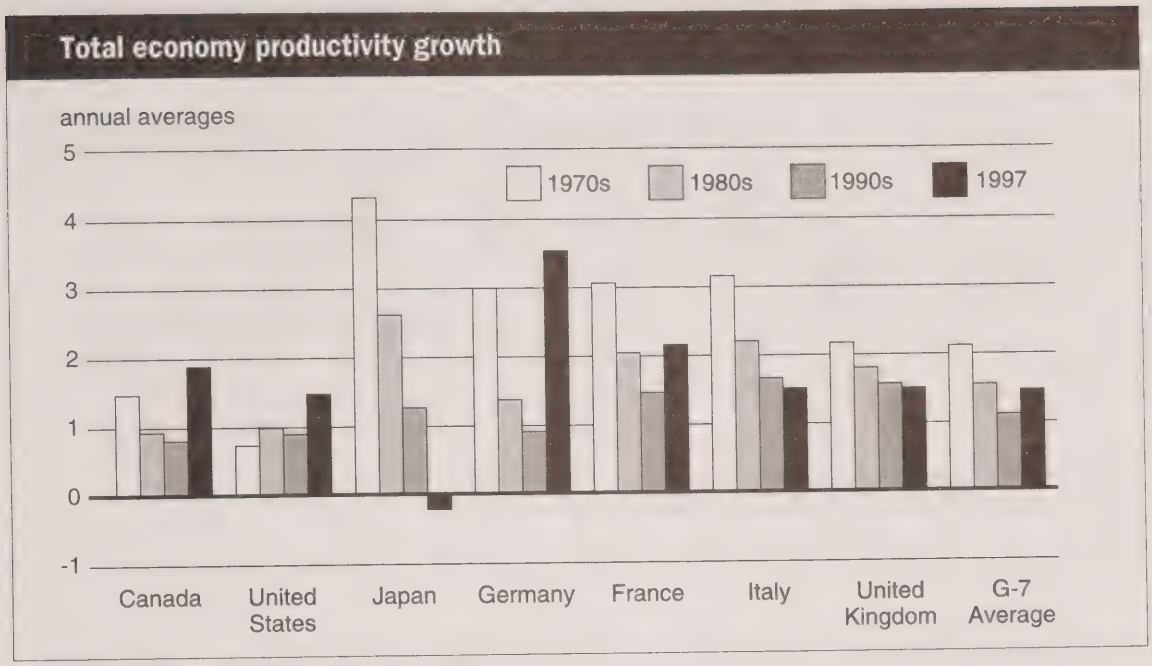
Canada has posted the second highest investment growth in the G-7.



Source: IMF *World Economic Outlook*, October 1998.

- Sound economic policies have contributed to strong growth in investment, a key factor in enhancing productivity growth.
- Canada has posted the second highest growth in business investment in the G-7 since 1993.
- Moreover, the IMF expects average growth in Canada's fixed investment to rise further in 1998 and 1999, and to post one of the best growth performances in the G-7.

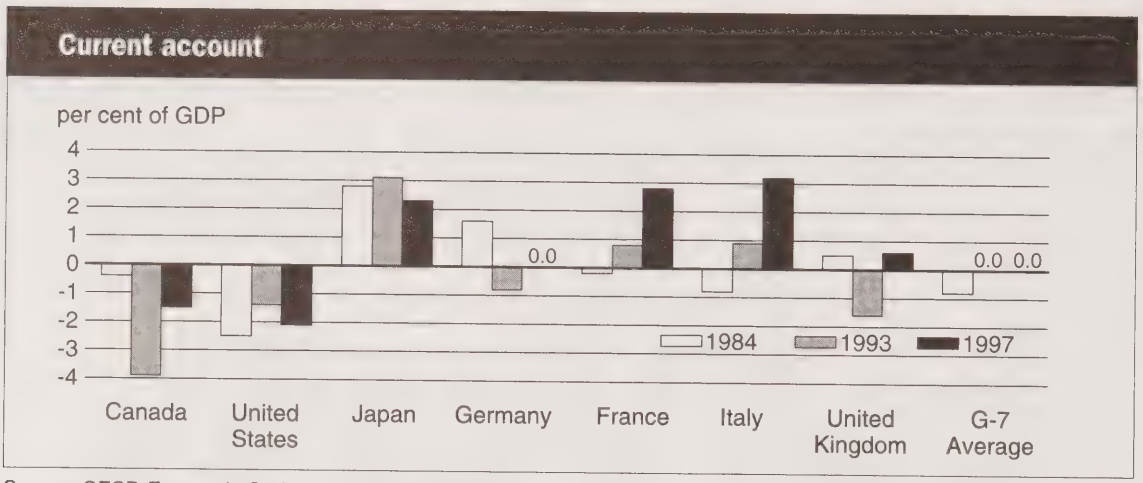
A key challenge for Canada is to improve its productivity growth.



Source: OECD *Economic Outlook,* June 1998.

- Canada, like other G-7 countries, has experienced a slowdown in productivity growth over the past three decades.
- Canada had the worst performance in the G-7 in the 1980s and early 1990s.
- Canada's productivity growth in 1997 was the best in more than a decade and better than the G-7 average. However, it is too early to say whether we have entered an era of higher productivity growth.
- To continue this performance, in addition to addressing macroeconomic imbalances, policy initiatives have been implemented aimed at improving productivity. These initiatives include increased support to R&D, technology diffusion, education and training.

Another challenge for Canada is to reduce its reliance on foreign savings further.



Source: OECD *Economic Outlook*, June 1998.
Note: 1997 data for Canada is the new revised data from Statistics Canada.

- Canada has traditionally had a current account deficit and thus has needed to rely on foreign capital.
- In the 1950s and 1960s, the current account deficit was associated with the need to finance strong domestic investment. But in the 1980s and early 1990s, the current account deficit was driven by the need to finance chronic fiscal deficits.
- The substantial improvement in Canada's fiscal position underpinned a significant improvement in the current account, which moved from a deficit of 3.9 per cent of GDP in 1993 to a deficit of 1.5 per cent in 1997.
- This means that Canada now borrows less from the rest of the world to finance its current account deficit.
- A challenge for Canada is to reduce its reliance on foreign savings further. This underscores the need for a continued prudent fiscal policy that helps to increase national savings and encourage private savings.

7

Key Facts on Tax and EI Premium Rate Reductions

Recent Federal Action to Lower EI Premiums and Personal Income Tax

- The federal government has already acted to leave more money in the pockets of Canadians in two areas: lower EI premiums and reductions in personal income tax.
- EI premium rates have declined significantly since 1994. The resulting cumulative reduction in EI revenues since 1994 is about $5 billion ($2.6 billion in 1998 alone).
- Some details of specific actions since 1994 are:
  - EI premiums were prevented from rising to $3.30 per $100 of insurable earnings in 1994;
  - EI premiums have been reduced each year since 1994 from $3.07 to the current level of $2.70 in 1998;
  - the New Hires Program announced in November 1996 provides relief to small firms that create jobs in 1997 and 1998. The total relief provided will be $465 million over the two years;
  - an EI premium holiday was announced in the February 1998 budget to provide relief for all firms for the new hiring of young Canadians for 1999 and 2000. The total relief will be $200 million over the two years; and
  - the maximum insurable earnings (MIE), the base for the calculation of maximum EI premiums, was lowered from $43,940 to $39,000 in 1996 and then frozen at that level. This provided relief of $1.8 billion over three years.
- The process of providing broad personal income tax relief was begun in the 1998 budget with $4 billion of general income tax cuts over three years. The total value of tax relief provided in the 1998 budget, including broad and targeted tax cuts, was $7 billion over three years.
- General tax relief to individuals was provided through:
  - a supplementary amount of income that can be earned on a tax-free basis of up to $500 for low-income individuals and $1,000 for low-income families; and
  - the elimination of the general 3-per-cent surtax for taxpayers with incomes up to about $50,000 and a reduction in the surtax for individuals with incomes between $50,000 and $65,000.

The Fiscal Cost of Tax and Premium Rate Reductions

- The following table provides a comprehensive list of rules of thumb for the fiscal cost of all key tax and premium rates.
- The one key message that emerges from this table is that any significant action in reducing personal income tax levels is very costly. For example:
  - a $100 tax reduction for all taxpayers would cost about $1.5 billion annually;
  - a 1-percentage-point reduction in the three tax rates of 17, 26 and 29 per cent would cost upwards of $3.7 billion annually; and
  - it would cost $1.1 billion annually to reduce the 26-per-cent rate facing middle-income Canadians by 1 percentage point.
- The cost of reducing EI premiums is also large:
  - a 5-cent reduction in the premium rate (7-cent reduction in employer premiums) would cost $350 million; and
  - reducing the premium rate to the break-even level could cost more than $6 billion annually.
- Given these costs, any action to leave more money in the pockets of Canadians would necessarily be modest in any single budget. However, the size of such relief should build up in the future as more fiscal resources become available, allowing the cumulative impact of such relief to grow over time.

Fiscal costs of tax and premium rate reductions: full-year impact estimates for 1999

	Cost of change ($ million)
Personal Income Tax	
$100 tax reduction for all taxpayers[1]	1,450
$100 increase in amounts used to established selected credits	
Basic personal amount	250
Married/equivalent-to-married amount	40
Federal surtaxes	
Reduction by 1 percentage point of the general 3% surtax[2]	350
Reduction by 1 percentage point of high-income 5% surtax[3]	130
Reduction in marginal tax rates (per percentage point)[4]	
Lowest rate (17%)	2,060
Middle rate (26%)	1,100
High rate (29%)	570
1 percentage point reduction in each rate	3,730
$100 increase in base benefit under Canada Child Tax Benefit[5]	600
$100 increase in GST credit for a family of four[6]	505
Restoring indexation of tax parameters[7]:	
Total impact:	
Year 1	840
Year 2	1,690
Year 3	2,550
Year 4	3,410
Components	
Personal credits and tax brackets:	
Year 1	610
Year 2	1,215
Year 3	1,825
Year 4	2,435
Canada Child Tax Benefit (CCTB):	
Year 1	160
Year 2	325
Year 3	495
Year 4	665
Goods and services tax credit (GSTC):	
Year 1	80
Year 2	160
Year 3	245
Year 4	330
Employment Insurance Premiums	
5-cent reduction in employee rate/7-cent change in employer rate (combined change)	
Employee 5-cent reduction[8]	145
Employer 7-cent reduction[8]	205
Total	350

Fiscal costs of tax and premium rate reductions: full-year impact estimates for 1999 *(cont'd)*

	Cost of change ($ million)
Business Income Tax	
1-percentage-point reduction in rates:	
All rates	780
Selected rates	
General rate (excl. M&P and small business income)	375
M&P rate	220
Small business rate	185
1-percentage-point change in the 4% surtax[9]	145
0.025-percentage-point change in the large corporations tax[10]	170
Sales Tax	
1-percentage-point change in GST[11]	3,000
1-cent-per-litre change in motor and aviation fuels	620
1-per-cent change in excise duties on:	
Spirits	5
Beer	5
Wine	1
Tobacco	20

[1] Non-refundable.

[2] The general 3% surtax was eliminated for all taxpayers earning less than $50,000 and reduced for those with incomes between $50,000 and $65,000 in the 1998 budget. The cost refers to the remainder of the surtax.

[3] Currently applies on basic federal tax in excess of $12,500 on an income level of about $65,000.

[4] 17% rate applicable to taxable incomes up to $29,590; 26% rate applicable to taxable incomes from $29,591 to $59,180; 29% rate applicable to taxable incomes from $59,181 and up.

[5] Current credit value of base Canada Child Tax Benefit (CCTB) is $1,020.

[6] Current credit value of goods and services tax credit (GSTC) depends on family type:
- $199 for the filer and spouse or equivalent-to-spouse; and
- $105 for each child.

[7] Estimates assume 1.5% annual inflation. Impacts are cumulative.

[8] Employers pay 1.4 times employee premium.

[9] On basic 28% federal corporate tax.

[10] Current rate of 0.225%.

[11] No change to GSTC.

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